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Statement of

John M. Reich, Director
Office of Thrift Supervision

concerning

Credit Card Lending

before the

Subcommittee on Financial Institutions and Consumer Credit
of the Committee on Financial Services
United States House of Representatives

June 7, 2007

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I. Introduction

Good morning, Madame Chair, Ranking Member Gillmor, and Members of the Subcommittee. Thank you for the opportunity to present the views of the Office of Thrift Supervision (OTS) on issues related to credit card lending in the thrift industry. Thank you also for your interest and leadership on this important aspect of the financial services market. According to recent Congressional testimony on the subject of credit card lending, in early 2006 there were approximately 190 million bank credit card holders in the U.S. during 2005 holding an average of seven credit cards who charged an average of $8,500.[1] The average outstanding credit card balance for American households with at least two adults who do not pay off their entire balances each month is over $13,000.[2] Clearly, credit card lending and practices are important and timely topics and I am pleased to be here to participate in this discussion and address your questions about the role of the thrift industry in credit card lending.

In my testimony today, I will discuss the thrift charter, authority for savings associations to issue credit cards and OTS authority to supervise the credit card activities of thrift institutions. I will also describe the credit card holdings of the industry and how thrifts issue credit cards, including the types of programs that are in place at various institutions. Next, I will explain how the OTS monitors and oversees the credit card activities of the industry and consumer complaints relating to credit card lending. Finally, I will address the adequacy of our authority to oversee credit card lending and provide

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1. Prepared statement of Robert D. Manning, PhD, Research Professor of Consumer Finance and Director of he Center for Consumer Financial Services, E. Phillip Saunders College of Business, Rochester Institute of Technology, Hearing on Examining the Billing Marketing, and Disclosure Practices of the Credit Card Industry, and their Impact on Consumers, US Senate Committee on Banking, Housing, and Urban Affairs, 1/25/07.

2. Ibid.

some preliminary observations on the Federal Reserve Board's (FRB) proposed modifications to Regulation Z.

II. Overview of the Thrift Charter and Thrift Credit Card Lending Authority

By statute, thrift institutions must maintain 70 percent of their assets in mortgages and mortgage-related assets; however, this requirement makes accommodation for certain retail lending activities of thrifts, including credit card lending. The purpose of this requirement and accommodation is to encourage a mortgage lending focus by thrifts, but also permit activities that are complementary to mortgage lending, such as consumer-based retail lending operations. This benefits consumers by increasing competition for these types of lending services and promotes asset diversification and balance in thrift operations by avoiding an over-reliance and overexposure to a limited and narrowly focused lending strategy.

The authority for thrifts to engage in credit card lending depends on whether the institution is state or federally chartered. The authority for state-chartered thrifts comes from state law, and the extent and scope of this authority varies depending on the jurisdiction. Generally, state chartered thrifts may engage in credit card lending, although there may be differing limits and/or other restrictions depending on the state.

The authority for federal thrifts to engage in credit card lending derives from the Home Owners' Loan Act (HOLA). Pursuant to the HOLA,[3] a federal savings association may invest in, sell, or otherwise deal in loans made through "credit cards or credit card accounts" without limitation as a percentage of assets to the extent specified by OTS regulations. OTS regulations permit federal thrifts to issue credit cards and maintain credit card accounts,[4] but impose no general limitation on credit card lending by federal thrifts. By regulation, however, the OTS may establish an individual limit on such loans if the agency determines that an institution's concentration in such loans presents a safety and soundness concern.[5]

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3. 12 USC § 1464(c)(1)(T).

4. 12 CFR § 560.3. Pursuant to this provision, a credit card is defined as "any card, plate, coupon book, or other single credit device that may be used from time to time to obtain credit." A credit card account is defined as "a credit account established in conjunction with the issuance of, or the extension of credit through, a credit card." These terms include loans made to consolidate credit card debt, including credit card debt held by other lenders, and participation certificates, securities and similar instruments secured by credit card receivables.

5. 12 CFR § 560.30.

III. OTS Authority to Supervise Thrift Credit Card Lending Activities

The general authority for federal thrifts to issue credit cards is subject to the authority of the OTS to supervise thrift credit card lending activities. OTS authority includes the ability to examine, regulate and, as noted above, limit for safety and soundness reasons the credit card operations of federal thrifts.[6] Pursuant to its authority to oversee the activities and operations of a federal thrift, the OTS is authorized to regulate, oversee and limit the credit card operations of a federal thrift that are in violation of consumer protection laws and/or that the agency determines pose a reputation risk – and thus a potential safety and soundness risk – to an institution.

IV. Thrift Industry Credit Card Holdings and Programs

A. Industry Holdings

As of March 31, 2007, OTS-regulated thrifts had total credit card holdings of $40.59 billion, or 2.7 percent of aggregate thrift industry assets. This amount represents approximately 11.5 percent of the aggregate $354.2 billion of credit card holdings of all FDIC-insured depository institutions. Eight OTS-regulated thrifts reported over $1 billion in credit card balances as of March 31, 2007. These institutions reported $39.56 billion outstanding, representing the vast majority (97.5 percent) of thrift industry holdings. By contrast, the remaining 126 thrift institutions that reported some level of credit card balances accounted for only $1.03 billion, or 2.5 percent of thrift industry credit card holdings. The industry-wide concentration in credit card holdings is further evident in that the 10 largest thrift credit card programs comprised 98.7 percent of thrift industry holdings.

On an aggregate basis, unused consumer credit card lines at OTS institutions totaled $618.8 billion in March 2007, up from $607.4 billion one-year prior. This represented 14.3 percent of the unused balance of $4.32 trillion of consumer credit card lines reported by FDIC-insured institutions as of March 31, 2007.

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6. Section 4(a) of the HOLA, 12 USC § 1463(a), provides that the OTS Director shall provide for the examination, safe and sound operation, and regulation of state- or federally-chartered savings associations. It further provides that the OTS may issue such regulations as the Director determines to be appropriate to carry out its responsibilities. In addition, HOLA section 5(a), 12 USC § 1464(a), provides that the OTS Director may prescribe the organization, incorporation, examination, operation, and regulation of federal savings associations. Finally, as previously noted, the OTS has specific authority to regulate the credit card activities of federal thrifts pursuant to HOLA section 5(c), 12 USC § 1464(c)(1)(T), which provides that a federal thrift may engage in credit card lending to the extent specified by OTS regulations.

Seventeen thrift institutions had credit card loan balances in excess of 10 percent of their risk-based capital. Nine of these institutions had credit card concentrations exceeding 100 percent of risk-based capital. Notwithstanding these levels, issuers continue to have strong capital positions supporting their credit card lending programs.

After showing some trends towards increasing delinquencies over the past few quarters, industry credit card delinquencies improved slightly in the first quarter of 2007. Credit card balances with payments between 30 and 89 days delinquent were 1.56 percent during the quarter, and balances 90 days past due were 1.44 percent. However, there was a continued increase in the level of charge-offs by OTS-regulated credit card lenders during the quarter. On an aggregate basis, adjusted net charge-offs were $540.4 million for the quarter, representing a 13.5 percent increase from the prior quarter. Although the level of increasing charge-offs warrants increased regulatory attention, the industry is coming off of historical low charge-off levels from one year ago. With the resolution of seriously delinquent credit cards, we expect that recent increases will moderate, but we are closely monitoring this area.

B. Industry Programs

Thrifts with significant credit card programs utilize various marketing channels, including:

- direct mail solicitations;
- partnership agreements with companies that make referrals on potential customers;
- retail marketing to customers; and
- branding so-called "private label credit cards" for consumer retailers that serve customers directly.

Of these, certain issuers also have programs that include products that are marketed to subprime borrowers. While these programs, in particular, present some supervisory challenges, issuers are generally responsive and focused on potential compliance problems arising from the marketing and servicing of subprime accounts. As described below, the OTS monitors these programs closely.

V. OTS Monitoring and Oversight

In addition to quarterly monitoring of the loan levels, performance and capital adequacy of thrifts engaged in credit card lending programs, the OTS monitors the marketing, pricing, fee and servicing practices of these programs. An important component of our oversight is examining for compliance with consumer protection laws, and particularly the account management and collection activities and practices of these institutions.

The OTS has a dedicated team of credit card specialists known as the Core Credit Card Specialty Group that works on continually improving our examination staff knowledge base, effectiveness, and inter-regional training program with respect to credit card oversight. Our Core Group staff assists our regional examiners in the review of our most complex credit card institutions and enhances cross-training efforts and the consistency of these examinations. Staff at the national office prepares specific quarterly monitoring reports and assigns core teams to assist in key selected institutions. For the thirteen institutions that have significant credit card operations, we currently have four examiners assigned to this core group. The group focuses on the major functional areas involved in credit card lending, including marketing, underwriting, account management, and collections activity.

We also have a consolidated examination structure that is unique among the federal banking agencies. This program, which has been in place for approximately four years, combines our safety and soundness and compliance examinations to better assess institution risks during the examination process. We have found that it also improves the assessment of risk within the industry and provides examiners with a broader examination perspective as well as broader developmental opportunities. And from a regulatory burden perspective, it is less intrusive to our institutions to have a combined safety and soundness and compliance exam, than to have two separate exams every exam cycle.

Part of the underlying rationale for this melded examination approach is that we believe compliance and safety and soundness should go hand in hand at an institution. Our examination teams have been conducting joint examinations and issuing one examination report for safety and soundness and compliance matters for the past several years. We believe this provides a more comprehensive assessment of an institution's risk profile and more accurately exposes weaknesses and deficiencies in an institution's overall program. Examining an institution's compliance with consumer protection laws and regulations along with its overall safety and soundness also provides us with an accurate assessment of an institution's overall business strategy.

Our safety and soundness and compliance examiners are subject to an intensive cross-training program to acquire the full knowledge and skills needed to lead melded examinations. We also maintain a cadre of compliance experts to assist examination teams in handling complex compliance matters. And our program staff has produced combined examination procedures, policies and handbook manuals that support this melded examination approach. The majority of responses from institutions have been overwhelmingly favorable regarding this examination format.

As set forth in OTS examination guidance,[7] OTS examiners look at all of the following areas in evaluating an institution's credit card lending program:

- subprime lending, marketing and servicing activities;
- credit scoring models used by thrifts to set applicable rates and fees;
- the existence of any unfair or deceptive acts or practices in the marketing or servicing of credit card accounts;
- compliance with Truth in Lending Act disclosure requirements;
- credit card collections and workout activity;
- delinquency, classifications, and charge-off policies;
- institution risks and controls (including fraud control) with respect to credit card lending activities;
- underwriting and account acquisition standards; and
- general account management and servicing procedures.

Because federal thrifts may conduct credit card lending programs subject only to the requirements of federal law, the OTS is required to ensure that federal thrifts conduct their credit card lending activities and programs in compliance with applicable consumer protection laws and subject to rigorous scrutiny of all aspects of an institution's program. In conducting its oversight of federal thrift credit card lenders, the OTS is particularly mindful of reputation risks that could undermine the safety and soundness of an institution and/or the federal thrift charter out of which an institution conducts its credit card operations.

As part of our examinations, we regularly examine thrifts for compliance with federal consumer protection statutes including the Truth in Lending Act and fair lending laws such as the Equal Credit Opportunity Act. We examine for compliance with our advertising regulation, which prohibits thrifts from making any representation that is inaccurate or that misrepresents its services, contracts, investments or financial condition.[8] We also examine thrifts for compliance with our nondiscrimination regulation, which prohibits thrifts from discriminating in lending and other services, appraisals, marketing practices and related areas.[9] Finally, long-standing OTS guidance provides that a thrift's collection activities must comply with the following:

- state laws that pertain to collection and foreclosure actions; and
- bankruptcy law – an institution's collection activity is affected by any bankruptcy plan into which a debtor has entered.

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7. Section 218, OTS *Examination Handbook.*

8. 12 C.F.R. § 563.27.

9. 12 C.F.R. Part 528.

An area of particular scrutiny with respect to credit card management practices in recent years is the application of minimum amortization standards by credit card lenders. Pursuant to guidelines issued by the federal banking agencies, credit card lenders are expected "to require minimum payments that will amortize a current loan balance over a reasonable period of time, consistent with the unsecured, consumer-oriented nature of the underlying debt and the borrower's documented creditworthiness."[10] The banking agencies also noted that prolonged negative amortization, inappropriate fees, and other practices that inordinately compound or protract consumer debt and disguise portfolio performance and quality raise safety and soundness concerns and are subject to examiner criticism.

OTS examiner guidance provides a more explicit interpretation of the interagency amortization guidelines, stating that "monthly payments should cover at least a one percent principal balance reduction, as well as all assessed monthly interest and finance charges."[11] Both the interagency credit card guidance and OTS examiner guidance allow for exceptions within well-managed credit card programs, consistent with prudent underwriting. While OTS-regulated thrifts vary slightly with respect to application of the one percent guideline, there are no cases currently outstanding where institution practices are unreasonable.

A. Consumer Complaint Activity

The OTS continually tracks, investigates and responds to consumer complaints involving thrift institutions with respect to product offerings and services, including credit cards. Consumer complaint staff and managers also prepare summaries of consumer complaints for OTS examiners to utilize in their reviews during on-site examinations.

We are also currently in the process of finalizing with the Conference of State Bank Supervisors (CSBS) a model memorandum of understanding (MOU) that we will be able to implement with various state banking supervisors to facilitate the sharing of consumer complaint data between the OTS and the states. The MOU is intended to promote the sharing of individual complaints for processing by the appropriate agency. It also provides for periodic reports of the number of complaints forwarded to the states or the OTS, the disposition of such complaints and other summary information. We have been working closely with the CSBS on this effort, and it is my understanding that the MOU will be finalized soon.

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10. Interagency Credit Card Lending, Account Management and Loss Allowance Guidance, January 8, 2003.

11. Section 218, OTS *Examination Handbook*.

Institution consumer complaint records are an integral part of the OTS individualized Pre-Examination Response Packages (PERK), which is our request to thrifts for data that will be used during the examination. This data plays a significant role in identifying areas for examiners to focus on during on-site examinations. These records also play a critical role in assessing the adequacy of an institution's overall compliance management program and in pursuing corrective action that may be appropriate to address programmatic weaknesses or deficiencies.

Specific complaint activity for particular institutions engaged in credit card lending varied considerably over the past year. Not unexpectedly, the largest issuers generally received higher numbers of consumer complaints. By contrast, the remaining institutions generated relatively few complaints in this area. The most frequent complaints related to credit card underwriting and credit bureau reporting. Typically, complaints in this area arise from Equal Credit Opportunity Act notices consumers receive because their application for a credit card or request for an increase in their credit card limit is declined.

Other common complaint areas involved billing errors; late fees and over limit fees; consumers' challenges to the accuracy of the annual percentage rate (APR) and finance charges arising from how the APR was calculated; customer service and consumer relations issues; collections activity; and problems encountered by consumers attempting to close a credit card account.

In addition to using consumer complaint data in connection with the supervisory oversight and examination of an institution, the OTS follows up with the institution on <u>all</u> consumer complaints filed with the agency. We impose a 60-day timeframe for the handling of consumer complaints by OTS staff and, in order to meet that goal, we work with thrifts promptly to request information needed to process and resolve a complaint. Due to the complexity of some complaints and related factors, it is not always possible to resolve a complaint within the designated timeframes; however, we track our response time closely. We typically process and conclude consumer complaint investigations within our designated timeframes. From January 2005 through May 2007, OTS staff processed and closed 94 percent of all consumer complaints we received within the designated 60-day timeframe.

Generally, we encourage institutions to work directly with consumers to attempt to resolve a complaint; however, OTS staff will become involved, when appropriate, to attempt to resolve a matter to the satisfaction of a consumer. We will also advise a consumer, upon completion of our review, if we believe that there is not a basis for the agency to compel the institution to take action or if it is our view that the institution properly handled the matter that generated the complaint. The OTS handles each

consumer complaint separately based on the facts and circumstances upon which the complaint is based.

It is important to note that our consumer complaint policy provides that even when evidence does not reveal regulatory violations, OTS complaint analysts and management have the flexibility and authority to encourage thrifts to take voluntary action to satisfy a consumer, where circumstances warrant such action. This happens fairly frequently in the interest of preserving strong customer relationships and further enhancing the reputation of thrifts as essential providers of financial services.

B. OTS Enforcement Activities

When an institution's lending programs are found to be potentially predatory or lacking adequate controls to support responsible lending, there are numerous options that the OTS can take to eliminate these risks. These include informal agreements, supervisory directives, board resolutions, and various other approaches. Our jurisdiction and oversight of an institution's lending programs also extends to the holding companies, affiliates, service providers, and other contractual relationships that an institution may utilize to conduct its credit card activities and related operations.

For example, we recently addressed an issue with an institution engaged in what we viewed as a potentially abusive subprime credit card lending program. The nature of the program was uncovered in the normal course of an examination. In connection with the resolution of that matter, we directed the institution's board of directors to establish a systematic process to withdraw from the subprime credit card program, and immediately cease new approvals under the program.

Although this was a more informal action pursued in the course of an examination, the result was that the program's growth was immediately terminated, and the program itself was unwound within a reasonably short timeframe following the examination. We have taken similar actions with other institutions in the past.

We have also exercised our enforcement authority outside of the credit card context to address transactions in which an institution enters into an agreement with an affiliated entity to originate and fund problematic loans through the institution. The OTS intervened in this matter after agency examiners determined that the thrift was not managing the relationship appropriately, insufficient controls were in place to fully ensure effective lending practices, and there was an indication of potentially abusive lending practices. In response, the OTS issued supervisory directives and required board resolutions to address the problem, including termination of the relationship between the thrift and the affiliated entity.

In other instances, the OTS has used a combination of formal and informal enforcement actions to force the discontinuation of lending operations by federal thrifts that were attempting to exploit the charter to engage in lending programs lacking adequate consumer protections and management controls. Some cases referred to as "charter rental" strategies involve situations where an institution is attempting to avoid state oversight of out-of-state lending activities by the institution. In addition to raising significant consumer protection issues, these situations not only expose the institution to potential risks, but undermine the integrity of the federal thrift charter. The OTS is particularly vigilant in intervening and expeditiously shutting down these types of operations.

There are numerous other such examples of actions taken by the OTS in the course of examinations of the institutions we regulate. While we find informal actions to be an effective mechanism to address these types of supervisory concerns, we do not hesitate to use our formal enforcement authority when appropriate to do so. Fundamental to our continuing oversight of the industry we regulate is ensuring that institutions conduct their activities in a manner consistent with sound consumer protection.

C. OTS Examiner Consumer Compliance Test

Pursuant to our program for monitoring and oversight of consumer protections, the OTS recently developed a new examination that is used to test and train OTS examiners regarding their level of proficiency across a broad range of consumer compliance laws and regulations. While we have always tested our examiners in this area, we developed this in-house examination to continue to ensure that OTS examiners have significant knowledge regarding consumer compliance requirements and agency expectations of the institutions that we regulate. The new test will assist us in working with our examiners to develop professionally to effectively examine thrift institutions, many of which have complex, retail-focused business models.

VI. Adequacy of Existing OTS Authority

As described above, I believe that the OTS has adequate existing authority to address the types of issues and potential abuses that may arise with the credit card lending programs of OTS-regulated thrifts. I do not feel that additional statutory authority is necessary at this time for the agency to continue effectively to supervise and regulate the credit card lending activities and practices of the thrift industry. At such time as a need should arise, I assure you that we will advise the Chair and Members of the Subcommittee of the need for legislative assistance to address any deficiency in our ability to supervise and/or respond to thrift credit card lending practices that pose consumer protection, safety and soundness, or other risks to the federal thrift charter.

VII. Proposed Revisions to Regulation Z

The Truth in Lending Act (TILA) enhances the information available to consumers regarding the cost of credit. Such information enables consumers to shop and compare credit options based on price and related terms. TILA also includes procedural and substantive provisions to protect consumers against inaccurate and unfair credit billing and credit card practices. TILA is implemented by the FRB's Regulation Z, which the FRB recently proposed revising.

In connection with the FRB's proposed revisions to Regulation Z, you have asked us to address a number of questions, including:

- What aspects of the FRB's proposal, if any, represent a significant improvement in consumer disclosure?
- Is the FRB's proposal sufficient to protect consumers in light of current credit card fee assessment, marketing, and other practices?
- What further measures should be considered?
- To what extent do issuers still use universal default, double-cycle billing, and retroactive rate increases?
- Has industry developed best practices and if so what are they?
- Have industry reforms been implemented for "subprime" credit card holders as well as "prime" customers?
- Is more information gathering needed regarding threats to consumers from "subprime" credit cards, and how can that be accomplished?

Given that the FRB's proposal is out for public comment and has not yet been published in the Federal Register, I do not think it appropriate to provide public comments on the specifics of the proposal at this time. I will, however, provide some general observations.

The FRB's proposed changes to Regulation Z apply to open-end credit not secured by a home. The FRB's proposal would amend aspects of Regulation Z pertaining to application and solicitation disclosures; account-opening disclosures; periodic statement disclosures; change-in-terms notices; and advertising provisions.

The OTS commends and supports the FRB on the comprehensive proposed amendments to Regulation Z. The proposed changes are the result of exhaustive and comprehensive analysis. In addition, the proposed new disclosures were the result of consumer testing and focus groups to determine readability and clarity for typical consumers. Clearly, and most importantly, the proposed overall changes were designed to enhance consumers' informed use of credit. As the FRB reviews the proposal, I would also encourage consideration of ways to address the cumulative impact of additional regulatory burden, particularly on smaller institutions, under the proposed rule.

The most significant changes in the proposal address:

- **Applications and Solicitations** – These changes would establish a new format for the "Schumer box"/summary table and include related changes designed to draw consumers' attention to key information. The proposed changes also require that creditors disclose the duration that penalty rates may be in effect, a shorter disclosure about variable rates, and new disclosures highlighting the effect of creditors' payment allocation practices (so consumers know how their payments will be credited and applied).

- **Account Opening Procedures –** These proposed changes would modify existing fee disclosure requirements to provide greater clarity for identifying and presenting fees that must be disclosed. The changes would also give creditors the option of disclosing charges (other than those required in the Schumer box) verbally or in writing.

- **Periodic Statement Disclosures –** These changes would group fees, interest charges and transactional information together to make the information easier to follow. The changes would also require disclosure of the effect of making only minimum payments.

- **Changes in a Consumer's Interest Rate and Other Account Terms** – The proposed change would increase from 15 days to 45 days the length of time that an institution must wait after giving notice to a consumer that the institution is changing the terms of credit. In addition, creditors would have to provide 45 days notice to a consumer before increasing the interest rate on an account due to a consumer's delinquency or default. These changes would allow borrowers more time to shop around for alternatives.

- **Advertising** – The proposal would require finance plan advertisements to display with equal prominence the minimum payment, the time period required to pay the balance, and the total of the payment if only minimum payments are made. In addition, ads referring to a "fixed" rate must specify the time period for which the rate is fixed and that the rate will not increase for any reason during that time. And if a time period is not specified, the rate would not be able to increase for any reason while the plan is open.

Generally, the most significant aspects of the FRB's proposed revisions to Regulation Z are those that provide consumers with more time, better practical disclosures, and more comparative information upon which to make important credit decisions. We certainly support the intent of these modifications and will more closely

review the proposal during the public comment period, and we look forward to reviewing the public comments submitted on the proposal.

Apart from an analysis of the FRB's Regulation Z proposal, it is worth noting, as previously observed, that thrifts engaged in significant credit card lending programs have taken the initiative in recent years to address many of the issues raised by the Subcommittee, including with respect to credit card fee assessment, marketing, and related practices. And we are working with the institutions we regulate to continue to encourage the development and use of best practices, where appropriate, with respect to credit card lending, pricing, fee setting, marketing, servicing, and collection practices.

We look forward to working with the FRB and the other banking agencies to address the issues raised in the FRB's Regulation Z proposal, as well as aspects of our current system that are not a subject of the proposal. In particular, we are pleased to be a part of this dialogue on existing credit card practices within the industry, and we look forward to a productive and ongoing dialogue on addressing issues such as double-cycle billing, universal default, and existing standards and safeguards available to subprime credit card borrowers.

VII. Conclusion

While credit card lending programs are not prevalent throughout the OTS-regulated thrift industry, there are a number of institutions that engage in significant amounts of credit card lending. For our part, we will continue to work with our institutions to ensure safe and sound underwriting standards and strong consumer protections that benefit both the institutions that we regulate and their customers. We will continue to monitor the revisions to Regulation Z proposed by the FRB, and support efforts to further strengthen the ability of consumers to make informed decisions with respect to their credit card accounts.

I applaud you, Madame Chair and Ranking Member Gillmor, for holding this important hearing on the credit card practices of banks and thrifts. Thank you for the opportunity to present the OTS's views on these issues.

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