January 30, 2004

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Re: Docket No. R-1167

Dear Ms. Johnson:

This letter is submitted in response to the Board of Governors' request for information regarding debt cancellation contracts ("DCCs") and debt suspension agreements ("DSAs") in its consideration of amendments to Regulation Z and the commentary on the regulation. The letter is submitted on behalf of the American Bankers Insurance Association and a coalition of companies that either issue or administer DCCs and DSAs. We appreciate the opportunity to provide this information.

Our letter is divided into two parts. First, we propose several revisions to Regulation Z related to DCCs and DSAs. Second, we provide some general background information on the structure, use, and regulation of these contracts and agreements.

Additionally, we interpret your request for information regarding debt cancellation and debt suspension products as the functional equivalent of an advance notice of proposed rulemaking, even though it was contained in a proposed rule announcement. Therefore, we strongly urge the Board to allow for additional comment on specific proposals before finalizing new standards.

I. Recommended Changes to Regulation Z

A. Conforming Section 226.4(d)(3) of Regulation Z to Current Market Practices

Currently, section 226.4(d)(3) of Regulation Z provides that the fees paid in connection with a DCC may be excluded from the disclosed finance charge if the following disclosure and affirmative election requirements are met:

(1) The consumer is told, in writing, that the purchase of the product is not required;

(2) The fee for the initial term is disclosed. (If the term of the contract is less than the term of the loan, the term of the contract also must be disclosed. The fee may be disclosed on a unit-cost basis in open-end credit transactions, closed-end transactions conducted by mail or telephone, and certain closed-end transactions involving a contract that limits the total amount of indebtedness subject to the contract.); and

(3) The consumer signs or initials an affirmative request for the contract after receiving the required disclosures.

This section does not accurately reflect current market practices for DCCs and DSAs. It only references fees paid in connection with DCCs, and is limited to DCCs that provide for the cancellation of all or part of a debtor's liability "in the event of the loss of life, health or income or in the case of accident." We respectfully recommend that the provision be modified to cover DSAs in addition to DCCs, and that the scope of triggering events for DCCs and DSAs be expanded to refer to any "specified event." DSAs are issued widely in connection with credit card loans and to some extent with other loan products; therefore, the regulation should explicitly recognize DSAs. Also, DCCs and DSAs increasingly are linked to a variety of events in the life of a borrower, not just death, disability or loss of income (such as family leave, military leave, etc.). Our proposed use of the term "specified event" would be consistent with the OCC regulation (see 12 C.F.R. 37.2(f) and (g)). If these proposed changes are made to section 226.4(d)(3), corresponding clarifying changes should be made to sections 226.4(b)(10) and 226.18(n).

We also recommend that section 226.4(d)(3) be revised to clarify that, in certain cases, the affirmative request may be provided orally. The new OCC DCC/DSA regulation permits oral consent for telephone solicitations and telephone responses to mail inserts or "take one" applications if certain requirements listed at 12 CFR 37.7(b)-(c) are satisfied. We propose that Regulation Z be amended to permit oral consent in those situations described in the OCC regulations.

B. <u>Disclosure of Fees in Connection with Closed-End Contracts and Agreements</u>

Currently, section 226.4(d) of Regulation Z allows a creditor to disclose a fee for DCCs on a unit cost basis for open-end credit, but limits unit cost disclosures for closed-end credit. We propose that unit cost disclosures be permitted for closed-end credit since many closed-end credit contracts often end up producing loan balances that are quite different from the scheduled balances that were predicted at the inception of the loan. In addition, we propose that the amount of a flat monthly fee be allowed to be disclosed. As DCCs and DSAs have evolved, single fee products are becoming less common. Some institutions have offered monthly fees (both on a flat and a unit cost basis) for closed-end transactions. Fees also are offered that may change from year to year or from an introductory period to a later period. Moreover, the OCC regulations referenced above require lenders to offer monthly fee products if they offer single fee products, and in some cases prohibit single fee products. In addition, many DCCs and DSAs allow the consumer to cancel the DCC or DSA at any time, so information about the amount of the required monthly fee or unit cost disclosure would be the most meaningful disclosure for the consumer.

C. <u>Conversions and Affirmative Election</u>

Currently, section 226.9(f) of Regulation Z requires credit card issuers to notify consumers with existing contracts before changing an underwriter of credit insurance. We believe it would be useful for the Board to impose a comparable disclosure requirement for conversions from credit insurance to either DCCs or DSAs (or *vice versa*). Absent such a requirement, creditors are not sure what, if any, obligations they have to a consumer in the event of such a conversion.

We would suggest that such a disclosure requirement apply to conversions in connection not only with credit card loans, but any type of loan that includes a monthly fee DCC or DSA. Since these contracts and agreements are offered in connection with all types of credit, general applicability of such a disclosure requirement seems appropriate.

The key to this requirement is properly defining what constitutes a "conversion." In our opinion, the disclosure should apply only in two circumstances: when a creditor switches from credit insurance to a DCC or a DSA (or *vice versa*), or when a creditor switches from a DCC to a DSA (or *vice versa*). Such changes constitute a material change between the creditor and the consumer.

As for the content of the disclosure, we recommend that the consumers be notified of (1) the nature of the change (*e.g.*, credit insurance to DCC or DSA (or *vice versa*); DCC to DSA (or *vice versa*)); (2) the fact that the contract or agreement is optional and can be cancelled; (3) the unit cost or nature of the fee or fees associated with the new product; (4) the types of events covered by the new product; and (5) the basic eligibility requirements and any applicable conditions or exclusions. We do not believe it is feasible to base the disclosure requirement on any standard such as a "substantial decrease in coverage." Like the notice required pursuant to section 226.9(f), a creditor should be able to provide this proposed disclosure notice in conjunction with or on a periodic statement.

Finally, while the OCC has imposed an affirmative election requirement with respect to the sale of DCCs and DSAs, there is no need for the Board to impose an affirmative election in conjunction with the proposed disclosure for conversions. The OCC imposed such a requirement in its regulation to ensure that the consumer intended to purchase the product. In the case of a conversion, the consumer already has decided to purchase a product that provides financial security should a specified event arise. Instead, as we suggest above, the consumer need only be reminded that the product is optional and can be cancelled.

II. Background Information

A. Differences Between DCCs and DSAs and Credit Insurance

As the Board has recognized, some lenders have stopped offering credit insurance and are instead offering DCCs and DSAs. This has occurred largely because the products provide a similar sense of financial security for borrowers, and because they have many advantages to both lenders and consumers when compared to credit insurance. DCCs and DSAs either cancel or suspend a borrower's obligation to repay a loan if a particular event occurs in the life of the borrower. There are, however, several differences between DCCs and DSAs and credit insurance policies.

First, and foremost, DCCs and DSAs are not insurance policies. Under a credit insurance policy, an insurance company assumes a borrower's obligation to repay a loan in the event of the death, disability or involuntary unemployment of the borrower. This assumption of risk is a fundamental characteristic of insurance. There is no similar assumption of risk under a DCC or

DSA. Under a DCC, a lender does not assume any investment risk or agree to make loan payments on behalf of the borrower. The lender simply cancels or suspends all or a portion of the outstanding loan or payments. Thus, as the Federal Court of Appeals for the Eighth Circuit concluded in the leading case on DCCs: the solvency of the lender is not a regulatory concern and such contracts are not "the business of insurance." (First National Bank of Eastern Arkansas v. Taylor, 907 F.2d 775 (8^{th} Cir. 1990)).

Second, DCCs and DSAs involve only two parties, not three. A credit insurance transaction involves a lender, a borrower, and an insurance company. A DCC or DSA, in contrast, is simply part of the loan agreement between a lender and a borrower. This distinction is important because it means DCCs and DSAs are not subject to one of the traditional criticisms directed against credit insurance, the charge of "reverse competition." Reverse competition is said to occur when an insurance company that underwrites credit insurance increases the commissions or other fees paid to a lender as an incentive for the lender to sell that company's policies to its loan customers. Supposedly, this upward pressure on commissions is the "reverse" of any downward pressure consumers may exert on premiums. State insurance regulators and consumer groups cite reverse competition to justify price controls for credit insurance. Since there is no third party insurer involved in a DCC or DSA, no such artificial pricing pressures exist with such contracts and agreements. The prices for DCCs and DSAs are set directly by a lender based upon normal competitive pressures and market acceptance.

Third, lenders have greater flexibility in designing these products. For example, state regulated credit insurance policies typically are only allowed to insure against the death, disability or involuntary unemployment of a borrower. A DCC or DSA can address the above as well as other types of life events that affect a borrower's ability to repay. We are aware of DCCs and DSAs that cancel or suspend a borrower's obligation to repay in the event of the birth or adoption of a child, a marriage or a divorce, a natural disaster, and even a call to active military duty. DCCs and DSAs also can include consumer-friendly provisions not authorized for credit insurance policies. For example, they may include provisions that guard against identity theft or fraud, special pricing breaks for consumers who do not smoke, and fee waivers during the period in which a loan is suspended. Lenders may even provide ancillary services to help borrowers cope with their ability to pay upon suffering a triggering event. Furthermore, DCCs and DSAs can apply not only to events in the life of a borrower, but also to events in the life of a spouse or other household member, even if that person is not a party to the loan. For borrowers living on two-incomes this can be a significant benefit. In addition, a lender doing business in multiple states can offer the same product in all states, rather than having to have multiple versions of a similar product as is the case with credit insurance.

In sum, while credit insurance and DCCs and DSAs provide consumers with a similar sense of financial security, there are significant differences between these products. As a result, it is difficult, if not impossible, to compare fairly DCCs and DSAs with credit insurance. Furthermore, as a general matter, it is inappropriate to subject DCCs and DSAs to state credit-insurance like regulations. To do so can have the unintended consequence of destroying the flexibility that allows these contracts and agreements to meet the changing needs of consumers. In our opinion, the disclosure and choice approach adopted by the Office of the Comptroller of the Currency ("OCC") for national banks is appropriate for regulating DCCs and DSAs. A summary of the OCC regulation on DCCs and DSAs is attached.

B. State Regulation; Some States Adopting OCC-Like Rules

As a general matter, most states permit their state-chartered banks to offer DCCs and DSAs and do not classify these contracts and agreements as insurance. We have found 35 states where the issuance of a DCC or DSA is a permissible activity under a parity statute or incidental powers clause, and where such contracts and agreements are not classified as insurance. Conversely, we have found 9 states that classify DCCs and DSAs as insurance. DCCs and DSAs offered by state-chartered banks in those states must conform to applicable state insurance regulations. Finally, we have found 6 states in which it is unclear whether or not DCCs would be classified as insurance, and one state (Iowa) that restricts the issuance of DCCs and DSAs by nonresident state-chartered banks.

In most of the 35 "permissive" states, the issuance of DCCs and DSAs by a state bank is not subject to specific regulation. However, since the issuance of the OCC's regulation, some states have adopted similar (if not identical) disclosure and choice regulations for their banks. States that have taken this action are Texas, Georgia and Utah. Some other states are examining the appropriate regulatory treatment of DCCs and DSAs at this time.

C. Product Types and Marketing Practices

One of the attractions of DCCs and DSAs is that they can be sold in connection with any type of closed-end or open-end loan. DCCs are commonly offered in connection with open-end credit card loans, home equity lines of credit ("HELOC") and closed-end mortgage and installment loans. Currently, DSAs are issued most commonly in connection with credit card loans. Also, some loans include hybrid contracts that have both DCC and DSA features.

Creditors typically link DCCs and DSAs to multiple triggering events. For example, it is not uncommon to find products that encompass benefits for the death, disability and/or unemployment of the borrower, just like credit insurance. Some contracts encompass additional "life events," such as the birth or adoption of a child, marriage, divorce, a call to active military duty, etc. Sometimes the customer is given a choice of which events/benefits, or packages of events/benefits, he wishes to purchase; but more commonly is just offered a single package or one type of benefit.

DCCs and DSAs are sold throughout the life cycle of a loan using all different media. That is, they are commonly sold face to face at the inception of or subsequent to the loan as well as via telemarketing and/or mail solicitations.

III. Conclusion

In conclusion, we appreciate the opportunity to address the treatment of DCCs and DSAs under Regulation Z and to provide the Board with some background information on these contracts and agreements.

Sincerely,

Beth L. Climo James C. Sivon James T. McIntyre

ATTACHMENT

SUMMARY OF OCC REGULATION

In September 2002, the OCC released a new regulation governing the issuance of DCCs and DSAs by national banks. This long-awaited regulation replaced the OCC's previous debt cancellation rule (12 CFR 7.1013) with a comprehensive set of consumer protection and safety and soundness requirements (12 CFR 37).

The regulation authorizes a national bank (and a federal branch or federal agency of a foreign bank) to offer both DCCs and DSAs. This authorization is based upon the general powers clause of the National Bank Act (12 USC 24(7)), which permits a national bank to engage in activities that are part of or incidental to the business of banking.

Under the OCC's previous debt cancellation rule, there was some question about the ability of the states to regulate DCCs and DSAs when offered by a national bank. The new regulation eliminates this uncertainty. It leaves no doubt that it is federal law, not state law, which governs DCCs and DSAs when they are offered by a national bank. It does this by explicitly preempting the application of state law. The preamble to the regulation explains the preemptive power of the regulation as follows:

> This final rule, together with any other applicable requirements of Federal law and regulations, are intended to constitute the entire framework for uniform national standards for DCCs and DSAs offered by national banks. Accordingly, the final rule states that DCCs and DSAs are regulated pursuant to Federal standards, including part 37, and not State law.

The regulation broadly defines DCCs and DSAs. A DCC is defined as a loan term or contractual arrangement modifying loan terms under which a bank agrees to cancel all or part of a customer's obligation to repay an extension of credit upon the occurrence of a specified event. The regulation does not otherwise define what is a "specified event." A DSA is defined as a loan term or contractual arrangement modifying loan terms under which a bank agrees to suspend all or part of a customer's obligation to repay an extension of credit from that bank upon the occurrence of a specified event. This definition is intended to cover DSAs under which interest continues to accrue during the suspension period, as well as those under which the accrual of interest is suspended. It also provides that a DSA does not include arrangements in which the borrower unilaterally decides to defer a payment or the bank unilaterally decides to allow a deferral of a payment, so-called "skip-a-payment" agreements.

While it chose not to regulate the price for DCCs and DSAs, the OCC did subject DCC and DSA fees to its existing regulation governing "non-interest charges and fees" (12 CFR 7.4002). That regulation provides that non-interest charges and fees should be set competitively in accordance with safe and sound banking principles, taking into consideration the following factors:

- the cost incurred by the bank in providing the service;
- the deterrence of misuse by customers of banking services;

- the enhancement of the competitive position of the bank in accordance with the bank's business plan and marketing strategy; and
- the maintenance of the safety and soundness of the institution.

The regulation also provides that non-interest fees are subject to traditional federal preemption standards applicable to national banks as federal instrumentalities, not to the preemption under 12 USC 85, which allows national banks to export "interest" rates from their home state.

The regulation does include restrictions on certain fee arrangements. Specifically, the regulation prohibits national banks from offering a single fee DCC or DSA in connection with residential mortgage loans. This prohibition is intended to ensure that the "abuses similar to those occurring in the credit insurance market [with single premium credit insurance] not develop with respect to DCCs or DSAs provided in connection with home mortgage loans." For purposes of this prohibition, a residential mortgage loan is defined as a loan secured by a 1- 4 family, residential real property.

The ban on single fee contracts and agreements does not apply to any other types of loans. Thus, a national bank may offer single fee contracts and agreements in connection with installment loans or open-end credit. However, the OCC has concluded that single fee contracts offered in connection with other loans "have the potential to be problematic." Thus, a national bank that offers a customer a single fee contract or agreement in connection with a non-residential mortgage loan also must offer the customer a "*bona fide*" periodic fee contract or agreement. The preamble to the regulation states that such an option will be "*bona fide*" as long as it is not deliberately priced to deter a customer from selecting the option.

The regulation addresses the refund of fees in the event a DCC or DSA is terminated or a loan is prepaid. It requires that a national bank that offers a no-refund contract or agreement also must offer the consumer a "*bona fide*" option to purchase a comparable contract or agreement with a refund feature. The OCC has suggested that an option is "*bona fide*" if it is not deliberately "structured" so as to deter a customer from selecting the refund option.

This "*bona fide*" refund option does not apply to open-end credit where customers pay for the contract or agreement on a monthly basis, such as credit card loans. In those cases, the OCC acknowledges that there are no unearned fees to refund to the customer.

In addition to the prohibition on single fee DCCs and DSAs issued in connection with residential real estate loans, the regulation prohibits national banks from tying the sale of DCCs and DSAs to extensions of credit, from engaging in misleading practices and advertising, and from unilaterally modifying the terms of the DCCs or DSAs.

The regulation requires a national bank to make certain disclosures to a customer before the sale of a DCC or DSA can be finalized. As a general matter, these disclosures must be made in writing, but there are certain exceptions to this requirement. Additionally, the regulation provides that the required disclosures take two forms, a short form or a long form, the use of which depends upon the context in which the national bank solicits a customer.

The regulation includes sample forms, but a national bank is not required to use these forms, as long as the basic disclosure requirements are met. Whether or not a national bank uses the model disclosure forms or designs its own, the disclosures must be "conspicuous, simple, direct, readily understandable, and designed to call attention to the nature and significance of the information provided." This requirement is identical to the disclosure standard contained in the OCC's insurance sales rule. Additionally, the disclosures must be in a meaningful form. The regulation provides several examples of methods a national bank could use to call attention to the nature and significance of the information in the disclosures. These include plain language headings, easy to read typeface and type size, wide margins, etc.

The regulation requires a national bank to obtain a customer's affirmative election to purchase a contract before the customer is obligated to pay for the contract. It also requires a national bank to obtain a customer's written acknowledgment of receipt of the required disclosures. Different procedures apply to these requirements, depending upon the solicitation method used by the bank. The disclosure, acknowledgment and affirmative election requirements also may be made electronically, provided they are consistent with the requirements of the Electronic Signatures in Global and National Commerce Act (15 USC 7001). Among other things, that Act requires an institution to obtain the consent of a consumer and to meet certain record retention requirements.

Finally, the regulation requires a national bank to manage the risks associated with these contracts in accordance with safe and sound banking principles. The regulation does not explicitly require a national bank to establish a reserve for these contracts or to purchase a contingent liability policy. On the other hand, it does direct national banks to establish and maintain effective risk management and control processes, and it states that effective risk management and control processes should include appropriate recognition and financial reporting of income, expenses, assets and liabilities, and appropriate treatment of all expected and unexpected losses.