BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DIVISION OF CONSUMER AND COMMUNITY AFFAIRS

DATE: April 28, 2008

TO: Board of Governors

FROM: Governor Kroszner
Committee on Consumer and Community Affairs

SUBJECT: Proposed Amendments to Regulation AA (Unfair or Deceptive Acts or Practices), Regulation Z (Truth in Lending), and Regulation DD (Truth in Savings)

The attached item has been reviewed by members of the Consumer and Community Affairs Committee and is now ready for Board consideration.

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SUBJECT: Proposed Amendments to Regulation AA (Unfair or Deceptive Acts or Practices), Regulation Z (Truth in Lending), and Regulation DD (Truth in Savings)

ACTION REQUESTED: Approval to publish for public comment proposed amendments to Regulation AA (Unfair or Deceptive Acts or Practices), Regulation Z (Truth in Lending), and Regulation DD (Truth in Savings).

- The amendments to Regulation AA would prohibit certain unfair or deceptive acts or practices by banks in connection with credit card accounts and overdraft services for deposit accounts, using the Board's rulemaking authority under the Federal Trade Commission Act (FTC Act).

- The amendments to Regulation Z would provide additional consumer protections for credit card accounts to complement the proposed amendments to Regulation AA. Aspects of the Board's June 2007 proposal would also be revised to improve the disclosures for credit card accounts and other open-end credit plans (not home-secured).

- The amendments to Regulation DD would require depository institutions to provide additional disclosures about overdraft services and fees to complement the proposed amendments to Regulation AA.

Summary

I. Regulation AA (Unfair or Deceptive Acts or Practices)

The Board has authority under the FTC Act to prescribe regulations to prevent unfair or deceptive acts or practices by banks. The Office of Thrift Supervision (OTS) and National Credit Union Administration (NCUA) have corresponding rulewriting authority for, respectively, savings associations and federally-chartered credit unions.

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OTS and NCUA are proposing rules substantially similar to those recommended by Board staff. The agencies' rules would apply to depository institutions that issue credit cards or pay overdrafts on consumer deposit accounts, with the exception of state-chartered credit unions.[1]

Staff recommends seeking comment on proposed amendments to Regulation AA to prohibit several unfair or deceptive acts or practices with respect to credit card accounts:

- Time to Make Payments. The proposal would prohibit institutions from treating a payment as late for any purpose unless the consumer has been provided a reasonable amount of time to make that payment. There would be a safe harbor for institutions that provide periodic statements at least 21 days prior to the payment due date. This proposal is discussed beginning on page 8.

- Allocation of Payments. When different annual percentage rates (APRs) apply to different balances on a credit card account (e.g., purchases, balance transfers, cash advances), institutions would have to allocate payments exceeding the minimum payment using one of three methods or a method equally beneficial to consumers, rather than the common method of allocating the entire amount to the balance with the lowest rate. An institution could, for example, split the amount equally between two balances or apply the payment pro rata. If, however, the creditor offered a promotional rate (e.g., on balance transfers), payments would be allocated to that balance last. This proposal is discussed beginning on page 10.

- Applying Rate Increases to Existing Balances. The proposal would prohibit institutions from increasing the interest rate on outstanding balances unless the increase is due to: (i) the operation of an index (i.e., the rate is a variable rate); (ii) the expiration or loss of a promotional rate (provided the rate is not increased to a penalty rate); or (iii) the minimum payment not being received within 30 days of the due date. This proposal is discussed beginning on page 14.

- Two-Cycle Billing. The proposal would prohibit institutions from imposing finance charges based on balances on days in billing cycles preceding the most recent billing cycle, a practice that is sometimes referred to as two-cycle billing. This proposal is discussed beginning on page 19.

[1] State-chartered credit unions are subject to the rulemaking authority of the Federal Trade Commission (FTC), as are financial services firms that are not depository institutions. Because the FTC is not joining this rulemaking, those entities would not be subject to the proposed rules.

- Financing of Security Deposits and Fees. The proposal would address concerns regarding subprime credit cards by prohibiting institutions from financing security deposits and fees for credit availability (such as account-opening fees or membership fees) if charges assessed during the first twelve months would exceed 50% of the initial credit limit. The proposal would also require security deposits and fees exceeding 25% of the initial credit limit to be spread over the first year, rather than charged as a lump sum at account opening. This proposal is discussed beginning on page 21.

- Firm Offers of Credit. The proposal would require institutions making firm offers of credit advertising multiple APRs or credit limits to disclose in the solicitation the factors that determine whether a consumer will qualify for the lowest APR and highest credit limit advertised. This proposal is discussed beginning on page 22.

- Credit Card Holds. The proposal would prohibit institutions from imposing a fee for exceeding the credit limit when the limit is exceeded solely because the institution placed a "hold" on available credit. This proposal is discussed beginning on page 23.

Staff also recommends seeking comment on proposed amendments to Regulation AA to prohibit depository institutions from engaging in unfair or deceptive practices related to overdrafts on deposit accounts:

- Right to Opt Out. The proposal would prohibit institutions from imposing a fee for paying an overdraft unless the institution has provided the consumer with a reasonable opportunity to opt out of the payment of overdrafts and the consumer has not done so. The opt-out right would apply, without limitation, to checks, automated clearinghouse (ACH) debits, ATM withdrawals, and debit card purchases at a point-of-sale (POS). Institutions also would be required to provide an opt-out for only the payment of overdrafts resulting from ATM and POS transactions. This proposal is discussed beginning on page 25.

- Debit Holds. The proposal would prohibit institutions from imposing an overdraft fee when the account is overdrawn solely because the institution placed a hold on funds in the consumer's deposit account. This proposal is discussed beginning on page 27.

II. Regulation Z (Truth in Lending)

Staff recommends seeking comment on proposed amendments to Regulation Z to address specific credit card practices, as a complement to the proposed amendments to Regulation AA:

- Due Dates for Mailed Payments. The proposal would prohibit creditors from requiring that mailed payments be received earlier than 5:00 p.m. on the due date in order to be considered timely. In addition, if a creditor does not receive and accept mailed payments on the due date (e.g., when the due date falls on a Sunday or holiday), a payment received by mail on the next business day would be considered timely. These proposals are discussed beginning on page 31.

- Right to Reject Cards with Substantial Fees. The proposal would address concerns regarding subprime credit cards by requiring creditors that assess security deposits and fees at account opening that exceed 25% of the minimum credit limit to notify consumers that, after receiving the account-opening disclosures, they can reject the credit card and avoid the fees (unless the consumer has made a payment on the card after receiving the billing statement or used the card). This proposal is discussed beginning on page 33.

- Deferred Interest Plans. The proposal would require written or electronic advertisements for deferred interest plans stating "no interest" or a similar term to disclose prominently the circumstances under which interest may be charged (e.g., if the balance is not paid in full by a certain date). This proposal is discussed beginning on page 34.

- Limiting the Issuance of "Substitute" Cards. Creditors would be prohibited from substituting a new general purpose credit card for an existing single-merchant card without the consumer's consent when the existing card has been "inactive" (i.e., the existing card has a zero balance and has not been used by the consumer for 24 months or longer). This proposal is discussed beginning on page 35.

Following a comprehensive review, the Board published in June 2007 proposed amendments to Regulation Z's rules for credit card accounts and other open-end plans that are not home-secured (June 2007 Proposal). That proposal would affect the format, timing, and content requirements for the five main types of open-end credit disclosures under Regulation Z: (1) credit and charge card application and solicitation disclosures;

(2) account-opening disclosures; (3) periodic statement disclosures; (4) change-in-terms notices; and (5) advertisements.

Staff also recommends seeking comment on proposed amendments to Regulation Z's disclosure rules in response to comments received on the June 2007 Proposal:

- Grace Periods. The Board's exemption authority would be used to eliminate the statutory requirement that creditors describe any interest-free period using the term "grace period." Based on consumer testing results, the proposal includes new language that is easier for consumers to understand. This proposal is discussed beginning on page 36.

- Minimum Finance Charge. Creditors would no longer have to disclose in their summary tables a minimum finance charge of $1.00 or less. This is discussed beginning on page 38.

III. Regulation DD (Truth in Savings)

Staff recommends seeking comment on proposed amendments to Regulation DD to address depository institutions' practices related to overdrafts, as a complement to the proposed amendments to Regulation AA:

- Disclosure of Right to Opt Out. The proposal would establish format, content, and timing requirements for disclosing consumers' right to opt out of overdraft services pursuant to Regulation AA. This proposal is discussed beginning on page 41.

- Disclosure of Aggregate Overdraft Fees. The proposal would extend to all institutions the requirement to disclose on periodic statements the aggregate dollar amounts charged for overdraft fees and for returned item fees (for the month and the year-to-date). Currently, only institutions that promote or advertise the payment of overdrafts must disclose aggregate amounts. This proposal is discussed beginning on page 43.

- Disclosure of Balance Information. The proposal would require institutions that provide account balance information through an automated system to disclose the amount of funds available for the consumer's immediate use or withdrawal, without including additional funds the institution may provide to cover overdrafts. This proposal is discussed beginning on page 44.

Discussion

I. Regulation AA (Unfair or Deceptive Acts or Practices)

Background on the FTC Act. The FTC Act generally prohibits unfair or deceptive acts or practices in commerce, and each of the federal banking agencies has authority to enforce this prohibition with respect to the institutions they supervise.[2] The FTC Act also authorizes the issuance of rules defining particular practices that are unfair or deceptive and grants rulemaking authority to the Board with respect to banks, OTS with respect to savings associations, and NCUA with respect to federal credit unions.[3] The FTC is responsible for issuing rules for other persons and entities but it must follow specific rulemaking procedures, including holding hearings to develop an evidentiary record.[4] Those procedures do not apply to the Board, OTS, or NCUA.

The Board has used its FTC Act rulemaking authority in the past to implement the FTC's Credit Practices Rule with respect to banks. That rule, which is contained in the Board's Regulation AA, addresses unfair contract provisions, unfair practices involving cosigners, and unfair late fees.[5]

Standards for Unfairness. Under the FTC Act, an act or practice is unfair where: (1) it causes or is likely to cause substantial injury to consumers; (2) the injury is not reasonably avoidable by consumers; and (3) the injury is not outweighed by

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[2] 15 U.S.C. 45(a); 12 U.S.C. 1818(b)(1), (e)(1), and (i)(2).

[3] 15 U.S.C. 57a(f)(1).

[4] 15 U.S.C. 57a(b)-(e), (g)-(j); 15 U.S.C. 57a-3.

[5] 12 CFR part 227. When the FTC issues rules under the FTC Act, the Board, OTS, and NCUA are required to issue substantially similar rules unless they make certain specified findings. 15 U.S.C. 57a(f)(1).

countervailing benefits to consumers or to competition.[6] Public policy may also be considered in this analysis but cannot be a determining factor. In March 2004, the Board issued guidance to state member banks, adopting these standards for purposes of enforcing the FTC Act.[7] Accordingly, staff has applied this test in determining whether an act or practice is unfair.

Standards for Deception. Although the FTC Act does not define deception, numerous courts have adopted the test used by the FTC. Under this test, an act or practice is deceptive where: (1) there is a representation or omission of information that is likely to mislead consumers acting reasonably under the circumstances; and (2) that information is material to consumers (i.e., it is likely to affect consumers' conduct or decisions regarding a product or service). The Board's March 2004 guidance to state member banks also adopts this standard. Staff has also applied this test for determining whether an act or practice is deceptive.

A. Proposed FTC Act Rules Addressing Credit Card Practices

Staff recommends publishing for comment proposed amendments to Regulation AA that would address unfair or deceptive credit card practices. In developing the proposal, staff has considered comments received in response to the Board's June 2007 Proposal. Staff has held meetings and discussions with consumer advocates, industry representatives, members of the Consumer Advisory Council, other federal banking agencies, and the FTC regarding credit card practices. Staff has reviewed consumer complaints and several studies of the credit card industry and has

[6] 15 U.S.C. 45(n).

[7] This guidance was issued jointly with the Federal Deposit Insurance Corporation (FDIC). The Office of the Comptroller of the Currency (OCC) has adopted similar guidance.

gathered information from recent Congressional hearings on credit cards. Staff's understanding of credit card practices and consumer behavior has also been informed by the results of consumer testing conducted in connection with the June 2007 Proposal.

1. Providing Consumers Adequate Time to Make Payments

Background. Based on concerns that consumers were receiving their credit card statements with little time remaining to mail their payments sufficiently in advance of the due date, the Board's June 2007 Proposal solicited comment on whether consumers were being provided with adequate time to make payments. The Board received comments from individual consumers, consumer groups, and a member of Congress indicating that consumers were not being provided with a reasonable amount of time to make their credit card payments. Some commenters stated that, because of the time required for mailed periodic statements to reach consumers and for consumers' mailed payments to reach creditors, consumers had little time in between to review their statements for accuracy. Commenters stated that, as a result, consumers' payments were sometimes received after the due date, leading to finance charges as a result of loss of the grace period, late fees, rate increases, and other adverse consequences.

Comments from industry, however, generally stated that consumers currently receive ample time to make payments, particularly in light of the increasing number of consumers who receive periodic statements electronically and make payments electronically or by telephone. These comments also stated that providing additional time for consumers to make payments would be operationally difficult and would reduce interest revenue, which would have to be recovered by raising the cost of credit elsewhere.

While an increasing number of consumers are receiving periodic statements and making payments electronically, information provided by creditors suggests that the majority of consumers still utilize mail. Although first class mail is often delivered within three business days, in some cases it can take significantly longer depending on when or where an item is mailed. Thus, a payment mailed well in advance of the due date may nevertheless arrive after that date. Furthermore, in order to exercise their rights under TILA and Regulation Z to dispute transactions or other items appearing on their periodic statements, consumers must have a reasonable amount of time to review their statement between receiving it and mailing their payment. Thus, an institution's failure to provide consumers with a reasonable amount of time to make payment appears to cause unavoidable injury to consumers. Although requiring institutions to provide consumers with more time to pay could lead to higher interest rates or late fees, these potential costs do not appear to outweigh the benefits to consumers of receiving a reasonable amount of time to make payments.

Summary of Proposed Revisions. The proposal would prohibit institutions from treating a payment as late for any purpose unless consumers have been provided a reasonable amount of time to make payment. Although the proposal does not mandate a specific amount of time, it would provide a safe harbor for institutions that have adopted reasonable procedures designed to ensure that statements are mailed or delivered at least 21 days before the due date. Compliance with this safe harbor would allow seven days for the periodic statement to reach the consumer by mail, seven days for the consumer to review the statement and make payment, and seven days for that payment to reach the institution by mail.

TILA currently requires that, if a creditor offers a grace period (i.e., a period of time during which consumers can avoid finance charges on purchases by paying the balance in full), the creditor must send periodic statements at least 14 days before the end of the grace period.[8] In order to avoid any potential conflict with this statutory requirement, the proposal would permit an institution to set one date for the expiration of the grace period and a later payment due date for all other purposes (e.g., imposition of late fees). However, because of the operational difficulties associated with providing two dates, staff anticipates that institutions will extend the grace period to coincide with the payment due date.

2. Allocating Consumers' Payments Among Multiple Balances

Background. Many credit card accounts have multiple balances at different interest rates. For example, an account might have a discounted promotional rate for balance transfers, a higher rate for purchases, and an even higher rate for cash advances. In the June 2007 Proposal, the Board discussed creditors' practice of allocating payments in excess of the minimum payment first to the balance with the lowest interest rate. For consumers who do not pay the balance in full each month, this practice can result in a higher assessment of interest charges than would be the case under a different allocation method. This practice is particularly disadvantageous for consumers who, for example, transfer a balance in response to a low promotional rate offer and then use the card for other transactions because allocating payments first to balances with the low promotional rate prevents the consumer from receiving the full benefit of the offer.

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[8] 15 U.S.C. 1666b(a).

Assume, for example, that a consumer responds to an offer of a 5% promotional rate on transferred balances for six months by opening an account and transferring $3,000. Then, during the same billing cycle, the consumer uses the account for a $300 cash advance (to which an interest rate of 20% applies) and a $500 purchase (to which an interest rate of 15% applies). If the consumer made a $800 payment, creditors would typically apply the entire payment to the promotional rate balance and the consumer would then incur interest charges on the more costly cash advance and purchase balances. Under these circumstances, the consumer is effectively denied the benefit of the 5% promotional rate for the full six months if the card is used for purchases or cash advances. The only way for the consumer to receive the full benefit of the 5% promotional rate on the transferred balance for the full six months, as advertised, is by not using the card for purchases or cash advances, which would effectively require the consumer to use an open-end credit account as a closed-end installment loan.[9]

In addition, creditors typically offer a grace period for purchases if a consumer pays in full each month but do not typically offer a grace period on balance transfers or cash advances. Because payments will be allocated to the promotional rate balance first, a consumer cannot take advantage of both a promotional rate and a grace period for purchases.

In preparing the June 2007 Proposal, staff conducted extensive consumer testing in an effort to develop disclosures explaining payment allocation methods so that

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[9] Deferred interest plans raise the same basic concerns. Many creditors offer deferred interest plans where consumers may avoid paying interest on purchases if the outstanding balance is paid in full by the end of the deferred interest period. A consumer whose payments are applied first to a balance on which interest is deferred instead of a balance on which interest is not deferred incurs additional finance charges and therefore does not receive the full benefit of the deferred interest plan. See page 34 for a discussion of deferred interest plans.

consumers could make informed decisions about card usage, particularly in regard to promotional rates. In this testing, many participants did not understand the effects of payment allocation or loss of the grace period, even after reading model disclosures that attempted to explain those effects. The June 2007 Proposal included a preliminary model disclosure and stated that the Board would continue to conduct testing to determine whether the disclosure could be improved. Although industry commenters were generally supportive of the proposed disclosure, consumer groups and individual consumers urged the Board to go further and prohibit payment allocation methods that apply payments to the lowest rate balance before other balances.

Staff conducted additional consumer testing of a simplified payment allocation disclosure in March 2008. Although some participants understood from prior experience that creditors typically apply payments to lower rate balances first and that this method results in higher interest charges, the revised disclosure did not enable consumers who were unfamiliar with payment allocation methods to understand their effects. Thus, disclosures do not appear to enable many consumers to avoid the higher interest charges caused by payment allocation practices. Furthermore, even if disclosures were effective, it appears that consumers still could not avoid higher interest charges by selecting a credit card account with more favorable terms because institutions almost uniformly apply payments first to the balance with the lowest rate and do not provide a grace period when a consumer carries a promotional rate balance.

<u>Summary of Proposed Revisions</u>. The proposal on payment allocation consists of three separate provisions. First, as a general rule, institutions would be required to allocate amounts paid by the consumer in excess of the minimum payment (excess

payments) among the different balances using one of three methods or another method that is no less beneficial to the consumer. The specified methods are: (1) allocating the excess payment first to the balance with the highest APR and any remaining portion to the other balances in descending order based on APR; (2) allocating equal portions of the excess payment to each balance; and (3) allocating the excess payment among the balances in the same proportion as each balance bears to the total outstanding balance (i.e., pro rata).

Second, the proposal would establish separate allocation requirements for accounts with promotional rate balances or balances on which interest is deferred to ensure that consumers receive the full benefit of the advertised offer. Under this provision, excess payments would be allocated first among the balances that are not promotional rate balances or deferred interest balances according to the general rule discussed above. Excess payments would be applied to promotional rate balances or deferred interest balances only if all other balances have been fully paid.

Third, the proposal would prohibit institutions from requiring consumers who are otherwise eligible for a grace period to repay any portion of a promotional rate balance or deferred interest balance in order to receive the benefit of the grace period on purchases. For example, if an institution provides a grace period on purchases to consumers who paid their balance in full the prior month, then the institution cannot refuse to provide a grace period on purchases to a consumer solely because that consumer transferred a balance in response to a promotional rate offer.

The proposed restrictions on payment allocation methods will likely reduce the revenue that institutions receive from interest charges, which may in turn lead institutions to increase rates generally or offer less favorable promotional rates or fewer deferred interest plans. Staff believes, however, that the proposal will ultimately enhance transparency and enable consumers to better understand the costs associated with using their credit card accounts at the time they engage in transactions. If promotional rates are higher, consumers who take advantage of promotional rate offers but do not use the card for other transactions may lose some benefit. To the extent, however, that costs are currently being understated up front for consumers who intend to use the card and therefore will pay higher interest charges later, the lower promotional rate does not represent a true benefit to consumers as a whole. Moreover, the proposal should enhance rather than harm competition because institutions offering rates that reflect consumers' actual costs would no longer be forced to compete with institutions promoting low rates that do not reflect consumers' true cost of using the card. Thus, the costs of the proposal do not appear to outweigh the benefits to consumers.

3. <u>Applying Rate Increases to Existing Balances</u>

<u>Background</u>. An increase in the interest rate that applies to prior transactions can come as a costly surprise to consumers who relied on the rate in effect at the time they engaged in those transactions. Penalty rates imposed by the creditor when, for example, a payment is late can be more than twice as much as the consumer's normal rate on purchases and may apply to all of the balances on a consumer's account for many months or permanently. Similar increases can be imposed based on factors not directly related to the account (such as a drop in a credit score or a default on a different account), a practice that is sometimes referred to as "universal default." In addition, creditors typically reserve the right to increase rates on existing balances at any time, for any reason (<u>e.g.</u>, to

reflect changes in the creditor's cost of funds or to increase revenues). In response to concerns about the practice of applying increased interest rates to existing balances, the June 2007 Proposal included revisions to Regulation Z requiring 45 days' advance notice of a rate increase so that consumers could shop for and obtain alternative sources of credit before the increase goes into effect.

Industry commenters generally stated that the 45-day notice requirement would delay creditors from increasing rates to reflect a consumer's increased risk of default, which could in turn cause creditors to charge higher rates at the outset of the account relationship and make credit less available to less creditworthy consumers. On the other hand, consumer groups, individual consumers, the OCC, and a member of Congress commented that notice alone was not sufficient to protect consumers from the harm caused by rate increases on existing balances. They noted that many consumers would not read or understand the proposed notice and that, even if they did, many would be unable to transfer the balance to a new credit card account with comparable terms before the increased rate went into effect. Some of these comments stated that creditors should be prohibited from increasing the rate on an existing balance in all instances. Other commenters (including the OCC) asserted that, when a rate increase on an account is not triggered by a late payment or other violation of the terms of that account, consumers should be given the right to opt out of the application of the increased rate to the existing balance by closing the account to new transactions.

Although the proposed 45-day advance notice of a rate increase would allow some consumers to refinance the debt to avoid higher interest charges, it appears that, in some cases, consumers may be unable to obtain replacement credit at a comparable rate.

Furthermore, it appears that many consumers cannot reasonably avoid the triggers that give rise to a rate increase. Consumers cannot avoid discretionary repricing that may be caused by changes in the creditor's cost of funds or by the creditor's desire to increase revenues. It also appears that consumers cannot reasonably avoid rate increases based on a decline in a credit score because the consumer may not have been aware of (or able to control) the factor that caused the drop in the score. For example, a consumer may be unaware that using a certain amount of the available credit on open-end accounts can lead to a reduction in a credit score. Nor can the consumer control how the creditor uses credit scores or other information to set interest rates.

Even when the increase is triggered by an event that violates the terms of the account or the terms of a different account (such as paying late or exceeding the credit limit), it appears that the rate increase may not be reasonably avoidable by many consumers. For example, consumers who carefully track their transactions may still exceed the credit limit because of amounts of which they were not aware (such as the creditor's imposition of interest or fees) or because of the institution's delay in replenishing the credit limit following payment. Furthermore, although the proposal would ensure that consumers receive a reasonable amount of time to make payment (as discussed above beginning on page 8), some consumers still may not be able to avoid a late or missed payment.[10]

Summary of Proposed Revisions. The proposal would prohibit institutions from increasing the interest rate applicable to an outstanding balance on a consumer credit card

[10] See, e.g., Statement of Basis and Purpose and Regulatory Analysis for FTC Credit Practices Rule, 49 FR 7740, 7747-48 (Mar. 1, 1984) (finding that the majority of defaults are not reasonably avoidable by consumers because of factors such as loss of income or illness).

account, except in three circumstances: (1) when the rate is increased due to the operation of an index (i.e., when the rate is a variable rate); (2) when a promotional rate expires or is lost due to a violation of the account terms, provided that the institution does not increase the rate to the penalty rate; and (3) when the minimum payment has not been received within 30 days of the due date.[11] Because this protection would be ineffective if consumers were not provided a reasonable amount of time to pay off the outstanding balance, the proposal would also require institutions to use one of two repayment methods or a method that is no less beneficial to the consumer. An institution could establish an amortization period of five years or longer, starting from the date on which the increased rate went into effect.[12] In the alternative, an institution could require a minimum payment on the outstanding balance that doubles the amount of the balance that was repaid before the effective date of the increase.[13] Finally, because the protections in the proposal would also be undercut if institutions were permitted to assess fees or other charges as a substitute for an increase in the interest rate, the proposal would prohibit institutions from assessing any fee or charge based solely on the outstanding balance.

[11] As discussed above, the June 2007 Proposal under Regulation Z would require institutions to provide 45 days advance notice of an increase in rate. This Regulation AA proposal, however, would not require an institution to provide consumers with 45 days in which to engage in transactions at the lower rate. Instead, the proposal would allow rate increases on transactions made more than fourteen days after the notice of the increase was provided to the consumer, although that increase could not take effect until the 45-day period expires. Consistent with proposed 21-day safe harbor for adequate time to make payment, the 14-day time period would allow seven days for the notice to reach the consumer by mail and an additional seven days for the consumer to review the notice and make arrangements to use alternative sources of credit for new transactions.

[12] This amortization period is consistent with guidance issued by the Board, OCC, FDIC, and OTS, under the auspices of the Federal Financial Institutions Examination Council (FFIEC), noting that credit card workout programs should generally strive to have borrowers repay debt within 60 months. See, e.g., Board Supervisory Letter SR 03-1 on Account Management and Loss Allowance Methodology for Credit Card Lending (Jan. 8, 2003).

[13] Many institutions calculate the minimum balance by adding interest charges and fees to a specific percentage of the balance (e.g., 1 or 2%). Under the proposal, an institution would be permitted to double this percentage with respect to the outstanding balance (although the rest of the minimum payment calculation method would have to stay the same).

While the proposal could lead to higher upfront costs and less available credit for consumers, consumers would benefit overall from a more transparent pricing structure for credit cards. Specifically, consumers would be able to more accurately assess the cost of using their credit cards at the time they engage in transactions, and would be less surprised by increases in the cost of transactions that have already been completed. Competition may be enhanced because institutions that offer interest rates that realistically reflect risk and market conditions will no longer be forced to compete with institutions that understate the true cost by offering artificially reduced rates at the outset with the expectation that the balances will be subsequently repriced. Furthermore, the proposal would not prohibit rate increases on outstanding balances in all circumstances. Institutions would still be able to reprice for risk in cases of substantial delinquency (i.e., when the account is 30 days delinquent). Institutions would also be able to guard against increases in the cost of funds by utilizing variable rates that reflect market conditions. Thus, the costs of the proposed rule do not appear to outweigh the benefits to consumers.

Staff considered, but rejected, the suggestion in some comments that consumers be permitted to opt out of the application of an increased rate to an existing balance so long as the consumer had not violated the terms of the account. This approach would not have addressed the harm to consumers whose rates were increased due to a minor infraction or an unavoidable violation of the account terms. Furthermore, even if an opt-out were provided in those circumstances, relatively few consumers would rationally choose not to opt out because few would benefit from application of an increased rate to an existing balance, particularly if the increased rate is significantly higher than the prior rate. But a substantial number of consumers may inadvertently forfeit their right to opt out by failing to read, understand, or act on the notice. In a 2006 report, the U.S. Government Accountability Office (GAO) noted that, although state laws applying to four of the six largest credit card issuers require an opt-out, representatives of those issuers stated that few consumers exercise that right.[14] Based on available information, staff believes that the proposal represents the better approach.

4. Computing Interest on Account Balances Over Two Billing Cycles

Background. Comments from consumers, consumer groups, and members of Congress on the June 2007 Proposal urged the Board to prohibit the balance computation method sometimes referred to as "two-cycle billing." This method can have several permutations but, generally speaking, an institution using the two-cycle method assesses interest not only on the balance for the current billing cycle but also on the balance for days in the preceding billing cycle. This method generally does not result in additional finance charges for a consumer who consistently carries a balance from month-to-month because interest is always accruing on the outstanding balance. Nor does the two-cycle method affect consumers who pay their balance in full within the grace period every month because interest is not imposed on their balances. The two-cycle method does, however, result in greater interest charges for consumers who pay their balance in full one month but not the next month.

The following example illustrates how the two-cycle method results in higher costs for these consumers. A consumer has a zero balance on a credit card account on

[14] U.S. Gov't Accountability Office, Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers at 26-27 (Sept. 2006). Because the opt-outs discussed in the GAO report only apply to non-penalty rate increases (which are generally much smaller than penalty rate increases), it may be that some of the low response rate is attributable to a rational consumer choice to accept the increase because a better rate could not be obtained elsewhere. On the other hand, the low response rate may be attributable to the way in which the opt out is disclosed, the manner in which consumers must exercise the opt-out, or other factors.

January 1, which is the start of the billing cycle. The consumer uses the credit card for a $500 purchase on January 15. The consumer makes no other purchases and the billing cycle closes on January 31. The consumer pays $400 on the due date (February 25), leaving a $100 balance. Under the average daily balance computation method that is used by most credit card issuers, because the consumer did not pay the balance in full on February 25, the periodic statement showing February activity (sent at the beginning of March) would reflect interest charged on the $500 purchase from the start of the billing cycle (February 1) through February 24 and interest on the remaining $100 from February 25 through the end of the billing cycle (February 28). Under the two-cycle method, however, interest would also be charged on the $500 purchase from the date of purchase (January 15) to the end of the January billing cycle (January 31).

Staff's consumer testing indicates that disclosures cannot adequately explain the two-cycle method in a way that enables consumers to avoid a card utilizing that method when comparing credit card terms. Furthermore, once consumers use a credit card, they have no control over the methods used to calculate finance charges.

<u>Summary of Proposed Revisions</u>. The proposal would prohibit institutions from imposing finance charges on balances for days in billing cycles preceding the most recent billing cycle. Two exceptions would apply. First, institutions would not be prohibited from charging consumers for deferred interest even though that interest may have accrued over multiple billing cycles. Thus, if a consumer did not pay a balance in full by the specified date under a deferred interest plan, the institution would be permitted to charge the consumer for interest accrued during the period the plan was in effect. Second, institutions would be permitted to adjust finance charges following resolution of a billing

error dispute. Because relatively few institutions still use the two-cycle method, the costs of the proposal do not appear to outweigh the benefits to consumers.

5. Security Deposits and Fees That Limit Credit Availability

Background. Subprime credit cards often charge to the account substantial security deposits or fees related to the issuance or availability of credit. For example, these cards may finance multiple one-time fees when the consumer opens the account (such as an application fee and a program fee) as well as an annual fee and a monthly maintenance fee. These amounts substantially reduce the consumer's available credit for purchases or other transactions. In addition, as interest accrues on these amounts, the available credit may continue to shrink.

In an effort to address complaints from consumers about subprime credit card fees, the June 2007 Proposal required creditors that assess substantial fees at account opening to disclose in solicitations the amount of credit that would remain for a consumer receiving the minimum credit limit. Further action may be needed, however, because cards with high fees and little available credit may not provide a substantial benefit to consumers. Subprime cards target consumers that may not have the positive credit history necessary to qualify for other, less-costly products. Because the proposed disclosure is based on the assumption that consumers will receive the minimum credit limit, some consumers may choose to apply for the card in the hope that they will qualify for a higher limit.

Summary of Proposed Revisions. The proposal would prohibit institutions from financing security deposits and fees for the issuance or availability of credit during the first year after account opening if, in the aggregate, those amounts constitute a majority of the initial credit limit. The proposal would also prohibit institutions from financing security deposits and fees that total more than 25% of the initial credit limit in the first billing cycle. Institutions would be required to spread amounts that exceed this threshold equally over the eleven billing cycles following the initial billing cycle. Security deposits and fees that are paid from separate funds would not be subject to the proposal.

6. Deceptive Firm Offers of Credit

Background. In a typical use of prescreening to make firm offers of credit under the Fair Credit Reporting Act (FCRA), a creditor obtains information from a consumer reporting agency about consumers who meet certain criteria (such as credit scores in a certain range). The creditor then sends a "firm offer of credit" to each of those consumers. The FCRA generally requires that consumers receive some offer of credit but does not require that consumers necessarily receive an offer on the terms listed in the solicitation. This practice may be deceptive when consumers are not informed that they may not qualify for the lowest APR and highest credit limit in the offer.

Summary of Proposed Revisions. The proposal would prohibit institutions from making firm offers of credit stating multiple APRs or credit limits (including a range of APRs or credit limits) without disclosing the criteria the institution will use to determine whether consumers will receive the lowest APR and highest credit limit. As an alternative to listing the criteria, an institution may make the following disclosure: "If you are approved for credit, your annual percentage rate and/or credit limit will depend on your credit history, income, and debts."

7. **Fees for Exceeding the Credit Limit Due to a Hold on the Account**

Creditors sometimes impose a "hold" on a consumer's available credit to preserve enough credit to cover a future transaction. The hold can exceed the amount of the transaction because the merchant does not know the exact amount of the charge at the time it seeks authorization from the card issuer. This is a common practice when cards are used to authorize charges in advance at hotels, restaurants, and automobile rental agencies. Consumers may be unaware of the hold placed on their available credit or they may be unaware of the amount of the hold and that their credit available has been effectively reduced. As a result, they may unknowingly engage in a transaction that exceeds their credit limit and incur a fee. As discussed below beginning on page 27, similar holds can be placed on deposit accounts when consumers use their debit cards.

Consumers are generally unaware of how holds affect their available credit. Accordingly, the proposal would prohibit institutions from charging a fee for exceeding the credit limit when the consumer exceeded the credit limit solely because of the hold.

B. **Proposed FTC Act Rules Addressing the Payment of Overdrafts**

Overdraft services are sometimes offered to transaction account customers as an alternative to traditional ways of covering overdrafts (for example, overdraft lines of credit or linked accounts).[15] Coverage is generally provided "automatically" to consumers that meet a depository institution's criteria (for example, the account has been open a certain number of days or deposits are made regularly). The service may extend

[15] Paying consumers' occasional or inadvertent overdrafts is a long-established customer service provided by depository institutions. The Board recognized this longstanding practice when it initially adopted Regulation Z in 1969. The regulation provides that these transactions are generally exempt from coverage under Regulation Z where there is no written agreement between the consumer and institution to pay an overdraft and impose a fee. See 12 CFR 226.4(c)(3).

to checks as well as other transaction types, such as ATM withdrawals, debit card transactions, recurring payments, and ACH debits. Most institutions state that payment of an overdraft is at their discretion. If an overdraft is paid, the consumer will be charged a flat fee for each item. A daily fee also may apply for each day the account remains overdrawn. Unlike a traditional line of credit, consumers are expected to repay all overdrafts and fees within a short time.

From the industry's perspective, the benefits of automated overdraft services include a reduction in the costs of manually reviewing individual items, as well as consistent treatment for all customers with respect to overdraft payment decisions. Industry representatives assert that overdraft services are valued by consumers (particularly for check transactions) because they avoid additional fees charged by a merchant if an item is returned unpaid and other adverse consequences, such as the furnishing of negative information to a consumer reporting agency.

In contrast, consumer advocates believe overdraft loans are a high-cost form of lending that trap low- and moderate-income consumers (particularly students and the elderly) into paying high fees. They note that consumers are enrolled into institutions' overdraft programs automatically, with no chance to opt out. Consumer advocates also believe that by honoring check and other types of overdrafts, institutions encourage consumers to rely on this service and thereby incur additional fees in the future. Consumer advocates are also troubled by debit card overdrafts where the dollar amount of the fee may far exceed the dollar amount of the overdraft, and multiple fees may be assessed in a single day based on a series of small-dollar transactions.

1. Consumer Right to Opt Out of Overdraft Services

Background. In response to the increased availability and consumer use of overdraft services, the federal banking agencies (FDIC, Board, OCC, OTS and NCUA) published guidance on overdraft programs in February 2005 (February 2005 Overdraft Guidance).[16] The guidance recommended as a best practice that institutions should obtain a consumer's affirmative consent to receive overdraft protection. As an alternative, where the consumer is automatically enrolled, the guidance stated that institutions should provide consumers the opportunity to "opt out" of the overdraft program and provide a clear consumer disclosure of this option.

Although many institutions allow consumers to opt out of overdraft services, this practice may not be uniform across all institutions. And, even when an opt-out is allowed, it may not be adequately disclosed. For example, some institutions may disclose the opt-out in a clause in their deposit agreement, but many consumers are unlikely to notice the clause, which may not be conspicuous or written in clearly understandable language. Opt-out notices may also be provided at a time when the consumer is unlikely to act. Many institutions provide notice of a consumer's right to opt out solely at account opening or when the service is initially added to the consumer's account, but do not provide notice at any other time. Thus, consumers are unlikely to receive notice about their right to opt out after experiencing an overdraft and incurring the associated fees, even though that may be the time at which the consumer is most likely to be focused on the merits and cost impact of the service.

[16] See Interagency Guidance on Overdraft Protection Programs (Joint Guidance), 70 FR 9127 (Feb. 24, 2005), and OTS Guidance on Overdraft Protection Programs, 70 FR 8428 (Feb. 18, 2005).

The GAO recently reported that overdraft fees have grown substantially over the past few years to just over $26 per item, indicating that consumers incur substantial monetary injury from overdraft fees.[17] In addition to per item fees, consumers may also incur additional daily fees for each day the account remains overdrawn. Consumers may not be able to avoid these fees unless they are informed of the overdraft service and provided an opportunity to reject that service.

Summary of Proposed Revisions. The proposal would prohibit institutions from assessing any overdraft fees unless the consumer is given notice and a reasonable opportunity to opt out of the overdraft service, and the consumer does not opt out. The consumer's right to opt out of an institution's overdraft service would apply to all methods of payment, including check, ACH, and other electronic methods of payment, such as ATM withdrawals and POS debit card transactions. Because, however, some consumers benefit from overdrafts paid for check and ACH transactions,[18] institutions would be required to provide consumers the option of only opting out of overdrafts in connection with ATM withdrawals and POS debit card transactions. Recognizing these benefits, the proposal also solicits comment on an alternative approach that would limit the right to opt out to overdrafts paid for ATM withdrawals and POS debit card transactions. Under the alternative approach, institutions may, but would not be required to, give consumers the option of opting out of overdraft services for check and ACH transactions.

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[17] See Bank Fees: Federal Banking Regulators Could Better Insure That Consumers Have Required Disclosure Documents Prior to Opening Checking or Savings Accounts, GAO Report 08-281 (January 2008).

[18] If a check or ACH is denied, the institution may charge a fee in the same amount as the overdraft fee. Furthermore, the merchant may also charge a fee as well as report negative information regarding the non-payment to a consumer reporting agency.

To allow consumers to avoid overdraft fees, the proposal would require notice of the opt-out to be provided prior to the institution's assessment of any fee or charge for paying an overdraft (for example, at account opening or at the time the overdraft service is established). The proposal would also require disclosure of the opt-out at least once during or for each periodic statement cycle in which any overdraft fee or charge is assessed to the consumer's account. This notice is intended to ensure that consumers – who may not focus on the significance of the information at account opening – are given notice of their right to opt out at a time that may be most relevant to them, that is, after they have incurred fees or charges for using the service. Of course, if the consumer opts out after having incurred an overdraft fee, the opt-out would apply only to subsequent transactions and the consumer would remain responsible for the fee. As further discussed below, to ensure that the opt-out right is presented in a clear and conspicuous manner and that consumers are able to make an informed choice, staff recommends that the Board also issue rules on the form and content of the opt-out notice using its authority under TISA (as discussed beginning on page 41).

If the consumer opts out, an institution could continue to pay overdrafts, but would not be able to charge a fee. Limited exceptions allowing the institution to charge overdraft fees despite a consumer's election to opt out are also provided in the proposed rule, including where the authorization amount is less than the actual transaction amount presented at settlement (for example, when a consumer leaves a tip at a restaurant).

2. Overdraft Fees Charged in Connection with Debit Holds

Background. Debit holds occur when a consumer uses a debit card for a transaction in which the actual purchase amount is not known at the time the transaction is authorized, causing the merchant to place a hold on the consumer's account for an amount that may exceed the purchase amount in order to protect the merchant against potential risk of loss. A hold may be placed for debit card transactions at pay-at-the-pump fuel dispensers, restaurants, or hotels. For example, for fuel purchases, card network rules may allow the merchant to place a hold of up to $75 on the consumer's account.[19] Similarly, a hotel may place a hold on the consumer's account in an amount sufficient to cover the length of the stay, plus an additional amount for incidentals, such as anticipated room service charges.

Typically, the hold is kept in place until the transaction amount is presented to the financial institution for payment and settled. For signature-based debit transactions, settlement may take up to three days following authorization under one card network's rules. Consumers unfamiliar with debit hold practices may inadvertently incur considerable overdraft fees on the assumption that the available funds in their account will only be reduced by the actual purchase amount of the transaction. For example, a consumer who purchases $20 worth of gas, but has a debit hold of $75 placed on the funds in the consumer's account, may not realize that an additional $55 has temporarily become unavailable to the consumer until the merchant presents the transaction for payment. During that time, the consumer may reasonably believe that they have only "spent" $20 and may spend more than the "available" balance, incurring overdraft fees in the process.

<u>Summary of Proposed Revisions</u>. Similar to the proposal on holds in the context of credit cards (discussed above beginning on page 23), the proposed rule would provide

[19] Other merchants may instead only place a pre-authorization hold of $1 in order to verify that the consumer's account is valid.

that an institution could not assess an overdraft fee when the account was overdrawn because of the hold. Staff believes that such a rule is appropriate because disclosures about the existence of the hold may not be noticed by consumers at the point of sale and might not convey the amount of the hold in individual cases.

II. Regulation Z (Truth in Lending)

Background on the Truth in Lending Act. Congress enacted TILA based on findings that economic stability would be enhanced and competition among consumer credit providers would be strengthened by the informed use of credit resulting from consumers' awareness of the cost of credit. The purposes of TILA are (1) to provide a meaningful disclosure of credit terms to enable consumers to compare credit terms available in the marketplace more readily and avoid the uninformed use of credit; and (2) to protect consumers against inaccurate and unfair credit billing and credit card practices.

TILA mandates that the Board prescribe regulations to carry out the purposes of the act. TILA specifically authorizes the Board, among other things, to do the following:

- Issue regulations that contain such classifications, differentiations, or other provisions, or that provide for such adjustments and exceptions for any class of transactions, that in the Board's judgment are necessary or proper to effectuate the purposes of TILA, facilitate compliance with the Act, or prevent circumvention or evasion.

- Exempt from all or part of TILA any class of transactions if the Board determines that TILA coverage does not provide a meaningful benefit to consumers in the form of useful information or protection. The Board must consider factors identified in the Act and publish its rationale at the time it proposes an exemption for comment.

- Add or modify information required to be disclosed with credit and charge card applications or solicitations if the Board determines the action is necessary to carry out the purposes of, or prevent evasions of, the application and solicitation disclosure rules.

- Require disclosures in advertisements of open-end plans.

Board's Review of Open-End Credit Rules. The goal of the June 2007 Proposal was to improve the effectiveness of the disclosures that creditors provide to consumers at application and throughout the life of an open-end (not home-secured) account, such as at account opening, on periodic statements, and when terms change. The time period creditors must wait to change key terms or increase rates would be increased under the proposal. In developing the June 2007 Proposal, the Board retained a research and consulting firm (Macro International) to assist the Board in using consumer testing to develop proposed model forms.

The Board received over 2,500 comments on the June 2007 Proposal. About 85% of these were from consumers and consumer groups, and of those, nearly all were from individuals. Commenters generally supported the June 2007 Proposal and the Board's use of consumer testing to develop revisions to disclosure requirements, although there was opposition to some aspects of the proposal. For example, industry representatives opposed many of the format requirements for periodic statements, as being overly prescriptive. Many industry commenters also opposed the Board's proposal to require creditors to provide at least 45 days' advance notice before certain key terms are changed or interest rates are increased due to default or delinquency. Consumers and consumer groups believe the Board's proposal was too limited in scope and urged the Board to provide more substantive protections and prohibit certain card issuer practices.

A. <u>Proposed TILA Rules Addressing Credit Card Practices</u>

Based on comments received on the June 2007 Proposal, staff recommends that the Board solicit comment on amendments to Regulation Z to would address certain credit card practices, as a complement to the rules proposed under the FTC Act.

1. <u>The Use of Early Cut-off Times for Receiving Mailed Payments</u>

Background. TILA generally requires that payments be credited to a consumer's account as of the date of receipt, provided the payment conforms to the creditor's instructions. Under Regulation Z, creditors are permitted to specify reasonable cut-off times for receiving payments on the due date. If a creditor imposes a cut-off time, it currently must be disclosed on the periodic statement; however, many creditors put the cut-off time on the back of statements. Some creditors use different cut-off times depending on the payment method.

In the June 2007 Proposal, the Board sought to address concerns that the use of certain cut-off times may effectively result in a due date that is one day earlier than the due date disclosed. (For example, some creditors have cut-off times of 12 p.m. and, in the past, as early as 9 a.m.) The proposal did not require a minimum cut-off time. Rather, the proposal requires creditors to disclose, near the payment due date on the front of the periodic statement, the earliest cut-off time for payments if it is before 5 p.m. on the due date.

Comments on the proposed disclosure were divided. Industry representatives that have different cut-off times for different payment methods (e.g., mail, telephone, Internet) expressed concern about consumer confusion if only one cut-off time is disclosed. Consumer groups urged the Board to eliminate cut-off times altogether or to establish a postmark-based system in which consumers who mailed their payments by a specific date would be considered timely regardless of when the payment was received.

Summary of Proposed Revisions. This proposal provides that, for mailed payments, it would be unreasonable for a creditor to set a cut-off time on the due date that is earlier than 5:00 p.m. at the location where payments are received. The proposal addresses only mailed payments and does not impose a single cut-off time for all methods of payment. This limited approach reflects concerns about the feasibility of specifying a single cut-off time, given the differences in creditors' processes and systems.

2. When Payment Due Dates Fall on a Holiday or Weekend

Background. The June 2007 Proposal did not address creditors' practice of using due dates on days that the creditor does not accept payments, such as weekends or holidays. In such cases, a consumer must pay one or more days early in order to avoid the imposition of fees or other penalties that are associated with a late payment. Comment letters indicated that, for many consumers, weekend and holiday due dates are a common occurrence. Some of these commenters suggested that the Board mandate an automatic grace period until the next business day for any weekend or holiday due dates. Other commenters recommended that the Board prohibit weekend or holiday due dates.

Summary of Proposed Revisions. The proposal would require a creditor to treat as timely any mailed payment received on the next business day when the due date for the payment is a day on which the creditor does not receive or accept payments by mail, such as a day on which the U.S. Postal Service does not deliver mail (e.g., a Sunday or a federal holiday). The proposal is limited to payments made by mail because a consumer must account for the time it takes for the payment to reach the creditor. The draft Federal

Register notice, however, solicits comment on whether the rule also should address payments made by other means, such as telephone payments or payments made via the Internet. In addition, comment is solicited on the burden associated with system changes that will be needed to backdate payments, waive fees and interest, or ensure that payment due dates fall on dates when the creditor receives mail.

3. Right to Reject Cards with Substantial Fees

Background. Currently, creditors must provide account-opening disclosures before the first transaction on an open-end plan. Regulation Z provides that creditors may assess membership fees before providing account-opening disclosures, if the consumer may reject the plan after receiving the disclosures and not be obligated for the fee. The Board proposed in June 2007 a disclosure targeted at subprime card accounts that assess security deposits and fees at account opening that exceed 25% of the minimum credit limit. Creditors generally must disclose in the account-opening table start-up fees (including membership fees) and creditors meeting the subprime threshold must also disclose an example of the amount of available credit the consumer would have after the fees or security deposit are charged to the account, assuming the consumer receives the minimum credit limit.

Summary of Proposed Revisions. The proposal would address concerns regarding subprime credit cards by requiring creditors to notify consumers that, after receiving the account-opening disclosures, they can reject the credit card and avoid the fees (unless the consumer has made a payment on the card after receiving the billing statement or used the account). This disclosure would apply only to credit card accounts that assess fees exceeding 25% of the minimum credit limit at account opening. The draft Federal Register notice, however, seeks comment on the scope of the proposed disclosure. Model language to comply with the disclosure requirement is proposed.

4. Advertising Deferred Interest Credit Plans

Background. Many creditors offer deferred interest plans where consumers may avoid paying interest on purchases if the outstanding balance is paid in full by the end of the deferred interest period. If the outstanding balance is not paid in full when the deferred interest period ends, these plans usually require the consumer to pay interest that has accrued during the deferred interest period. Moreover, these plans typically begin charging interest from the date of purchase if the consumer defaults on the credit agreement, which may include failure to make a minimum payment during the deferred interest period. In some cases, advertisements prominently disclose the possibility of financing the purchase of goods or services at "no interest" without adequately disclosing that the consumer will be charged interest under certain circumstances.

Summary of Proposed Revisions. The proposal would address concerns that the disclosures currently required under Regulation Z may not adequately inform consumers of the terms of deferred interest offers. Specifically, the proposal would require that, in advertisements for deferred interest plans, the deferred interest period be disclosed in immediate proximity to each statement regarding interest or payments (e.g., "no interest for 12 months"). Information about the terms of the deferred interest offer would also be disclosed in close proximity to the first statement regarding interest or payments during the deferred interest period. The proposal incorporates many of the concepts proposed in the June 2007 Proposal for advertising introductory (promotional) rates.

5. Additional Protections Related to Issuing "Substitute" Cards

Background. TILA generally prohibits creditors from issuing credit cards except in response to a request or application, but explicitly exempts from this prohibition credit cards issued as renewals of, or substitutes for, previously accepted credit cards. The Board has used its authority to interpret what actions constitute a "substitution" under the statute. The staff commentary to Regulation Z provides guidance on actions card issuers may take to "substitute" a new card for an accepted card. For example, if the originally accepted card is honored only at Merchant A, the creditor may issue a substitute card if the new card continues to be honored by Merchant A, even though the card may also be used at Merchant B or other merchants. Card issuers have relied on this interpretation to substitute, on an unsolicited basis, a general-purpose bank card that is honored at many merchants for a card originally honored by a single merchant (i.e., a retail card).

The June 2007 Proposal did not address the substitution of cards. In their comments on this proposal, consumer groups urged the Board to prohibit issuers from issuing, on an unsolicited basis, a new card for an accepted card if the credit features differ greatly or if the accepted card has not been used for an extended period of time. Citing concerns about cardholder security and identity theft, consumers also suggested that the Board require issuers to obtain consumers' consent or to warn consumers when new cards are sent in substitution for cards that have not been used for some time.

Summary of Proposed Revisions. The proposal would limit a card issuer's ability to issue, on an unsolicited basis, a new card as a substitute for an existing card where the merchant base that will honor the new card (other than the addition of an affiliate of the merchant) would be expanded, such as from a card that is honored by a single merchant to a general-purpose card. Under those circumstances, the card issuer would not be permitted to substitute the new card for the accepted card without a specific request or application if the account is "inactive" (i.e., the account does not have an outstanding balance and has been not been used for an extension of credit for the 24-month period preceding the issuance of the substitute card).

The proposal would address consumers' confusion and concerns about identity theft when a card issued by a creditor with whom the consumer may have no previous relationship arrives in the mail on an unsolicited basis, as a substitute for a retail card account the consumer has not used in some time.

B. Proposed Disclosure Rules Under TILA

1. Grace Periods

Background. Currently, TILA and Regulation Z require card issuers to use the term "grace period" in the summary table provided with credit and charge card applications or solicitations to describe the date by which consumers can pay any credit extended for purchases without incurring a finance charge. For consistency, the Board's June 2007 Proposal extended the requirement to use the term "grace period" to other disclosures, such as the account-opening summary table.

Consumer testing conducted in connection with the June 2007 Proposal indicated that some participants misunderstood the word "grace period" to mean the time after the payment due date that an issuer might give the consumer to pay the bill without charging a late payment fee. The GAO in its Report on Credit Card Rates and Fees found similar misunderstandings by consumers in its consumer testing.[20] The Board proposed,

[20] GAO, Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers, 06-929 (September 2006).

however, to retain the use of the statutorily required term in the June 2007 Proposal, based on consumer testing showing that participants understood the term more clearly when additional context was provided. Thus, the June 2007 Proposal would have required card issuers to disclose briefly the conditions applicable to the grace period to aid in consumers' understanding.

One card issuer commenting on the June 2007 Proposal performed its own testing with consumers on the grace period disclosure and found that the term "grace period" was still confusing to consumers, even with the additional context given in the grace period disclosure proposed by the Board. The commenter found that consumers understood the term "interest-free period" to more accurately describe the interest-free period between the purchase and the due date for customers who pay their balances in full. Staff also tested the phrase "interest-free period" prior to issuing the June 2007 Proposal, with mixed results. Staff conducted additional testing in March 2008, which indicated that labeling the information "How to Avoid Paying Interest on Purchases" (or applicable transactions) was easier for consumers to understand.

Summary of Proposed Revisions. The proposal would delete the requirement to use the term "grace period" in the disclosure table required for credit and charge card applications or solicitations, using the Board's exemption authority under TILA. In its place, the proposal would require the use of headings that label the information "How to Avoid Paying Interest on Purchases" (or applicable transactions). The proposal also contains model language that creditors may use to explain their grace periods.

2. **Disclosing the Minimum Finance Charge**

Background. Currently, TILA and Regulation Z require card issuers to disclose any minimum or fixed finance charge that could be imposed during a billing cycle. Creditors typically impose a minimum charge (e.g., $.50) in lieu of interest in those months where a consumer would otherwise incur an interest charge that is less than the minimum charge (a so-called "minimum interest charge"). The June 2007 Proposal retained the minimum finance charge disclosure in the tables required to be disclosed for credit card applications and solicitations and at account opening.

In response to the June 2007 Proposal, several industry commenters recommended that the Board delete this disclosure from the table unless the minimum finance charge is over a certain nominal amount. They indicated that, in most cases, the minimum interest charge is so small as to be irrelevant to consumers, and noted that the purpose of the summary table is to highlight the most relevant terms that consumers use in evaluating credit card offers or deciding how to use their account.

Summary of Proposed Revisions. Under the proposal, creditors would no longer have to include a minimum or fixed finance charge of $1.00 or less in the summary table provided with applications or solicitations and at account opening. The $1.00 amount would be adjusted based on changes in the Consumer Price Index, rounded to the next whole dollar. The draft Federal Register notice seeks comment on whether $1.00 is the appropriate initial threshold amount. Staff believes the nominal amount of the dollar threshold is sufficiently low that consumers are unlikely to make uninformed credit decisions based on the absence of the minimum finance or interest charge in the summary tables.

III. Regulation DD (Truth in Savings)

Background on the Truth in Savings Act. The purpose of TISA is to assist consumers in comparing deposit accounts offered by depository institutions, principally through the disclosure of fees, the annual percentage yield, the interest rate, and other account terms. The Board's Regulation DD implements TISA.[21]

Under the act and regulation, disclosures about account terms must be provided to a consumer before an account is opened, or upon the consumer's request. Institutions are not required to provide periodic statements to consumers but, if they do, the act and regulation require fees, rates, and other information to be provided on the statements. Notice must be given to accountholders before an adverse change in account terms occurs.

The act and regulation also contain rules for advertising deposit accounts. There is a statutory prohibition against advertisements, announcements, or solicitations that are inaccurate or misleading, or that misrepresent the deposit contract. Institutions are also prohibited from describing an account as free (or using words of similar meaning) if a regular service or transaction fee is imposed, a minimum balance must be maintained, or a fee is imposed when a consumer exceeds a specified number of transactions.

TISA authorizes the Board to prescribe regulations to carry out the purpose and provisions of the statute.[22] The act expressly states that the Board's regulations may contain "such classifications, differentiations, or other provisions, . . . as, in the judgment of the Board, are necessary or proper to carry out the purposes of [the Act], to prevent

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[21] Regulation DD covers all depository institutions other than credit unions; the National Credit Union Administration is required to issue a substantially similar regulation for credit unions.

[22] 12 U.S.C. 4308(a)(1).

circumvention or evasion of the requirements of [the Act], or to facilitate compliance with the requirements of [the Act]."[23]

Recent Agency Actions Addressing Overdraft Services. As discussed above beginning on page 23, some institutions automatically provide certain consumers with a service that assesses a fee for paying transactions that overdraw the account. The February 2005 Overdraft Guidance published by the federal banking agencies included best practices focusing on institutions' marketing and communications about overdraft services as well as program features, including providing consumers an election or opt-out of the overdraft service.[24]

In May 2005, the Board issued revisions to Regulation DD and the staff commentary pursuant to its authority under TISA to address concerns about institutions' disclosure of overdraft fees generally and the advertisement of overdraft services in particular.[25] The goal of the final rule was to improve the uniformity and adequacy of disclosures provided to consumers about overdraft and returned-item fees in order to assist consumers in better understanding the costs they may incur in connection with the payment of overdrafts. In addition, the final rule addressed concerns about institutions' marketing practices with respect to overdraft services.

[23] 12 U.S.C. 4308(a)(3). The Board's regulations also may contain adjustments and exceptions for particular classes of accounts.

[24] See Interagency Guidance on Overdraft Protection Programs (Joint Interagency Guidance), 70 FR 9127 (Feb. 24, 2005) and OTS Guidance on Overdraft Protection Programs, 70 FR 8428 (Feb. 18, 2005). The OTS guidance focused on safety and soundness consideration and best practices.

[25] 70 FR 29582 (May 24, 2005). A substantively similar rule applying to credit unions was issued separately by the NCUA. 71 FR 24568 (Apr. 26, 2006). The NCUA issued an interim final rule in 2005. 70 FR 72895 (Dec. 8, 2005).

Among other provisions, the May 2005 final rule requires institutions that promote the payment of overdrafts in an advertisement to disclose on their periodic statements the total dollar amount of fees or charges imposed on the deposit account for paying overdrafts, and the total dollar amount of fees imposed for returning items unpaid. These disclosures must be provided for the statement period and for the calendar year.

A. Proposed Disclosure Rules under TISA

Staff recommends publishing for comment several proposed changes to the disclosures rules in Regulation DD relating to institutions' payment of overdrafts.

1. Disclosure of Right to Opt-Out

Background. The proposed amendments to Regulation AA would prohibit depository institutions from assessing any fees or charges for paying an overdraft on a consumer's account unless the consumer has been given notice and an opportunity to opt out of an institution's payment of overdrafts and has not done so. That proposal would require that notice be given both before the institution assesses any fees in connection with paying an overdraft (for example, at account opening or at the time the overdraft service is established) and at least once during or for each statement period in which a consumer is assessed a fee or charge.

Summary of Proposed Revisions. Pursuant to general rulemaking authority and other TISA provisions, the proposal would amend Regulation DD to require that the opt-out notice state the following (as applicable):

(1) The categories of transactions for which an overdraft fee may be imposed (for example, checks, ATM withdrawals, and POS debit card transactions);

(2) The fees or costs imposed, including per item and daily fees;

(3) That overdraft fees could be charged in connection with an overdraft as low as $1, or the lowest dollar amount for which the institution could charge a fee;

(4) Any limits on the maximum costs that could be incurred per day or per statement period in connection with the overdraft service;

(5) An explanation of how the consumer can opt out (for example, a telephone number the consumer may call to opt out, or by mailing a form); and

(6) A statement whether the institution offers any alternatives for the payment of overdrafts, including whether the institution offers an overdraft line of credit.

The disclosures are intended to alert consumers to the potentially high costs of overdraft services, so that they may more effectively determine whether the account terms meet their needs or whether other alternatives would be more appropriate. Consumer testing of a proposed model form is planned following issuance of the proposal to determine if the proposed content will be useful to consumers in assessing the benefits of using their institution's overdraft service and to evaluate if the information presented is easily understandable.

The proposal specifically contemplates that, when notice is provided on a periodic statement, it be provided close to information about the overdraft fees incurred by the consumer. Alternatively, many institutions notify consumers promptly after paying an overdraft. While this separate notice is not required by Regulation DD, it is considered a best practice under the February 2005 Overdraft Guidance. Under the proposal, institutions providing an opt-out disclosure on notices sent following each overdraft would be deemed to comply with the timing requirements for providing an opt-out with periodic statements. Institutions would be required to provide the opt-out notice only once per cycle, however.

2. Disclosure of Aggregate Overdraft Fee Information

Background. The May 2005 final rule requires institutions that promote the payment of overdrafts in an advertisement to disclose on their periodic statements the total dollar amount of fees or charges imposed on the deposit account for paying overdrafts and the total dollar amount of fees imposed for returning items unpaid. These disclosures must be provided for the statement period and for the calendar year to date.

In limiting the aggregate fee disclosures to institutions that market overdraft services in the May 2005 rule, the Board sought to avoid imposing compliance burdens on institutions that pay overdrafts infrequently, such as institutions that only pay overdrafts on an ad hoc basis. Since issuance of the May 2005 final rule, however, questions have been raised regarding when an institution is deemed to be promoting the payment of overdrafts in an advertisement and whether the aggregate fee disclosures are required. For example, staff has received a number of inquiries about how institutions may inform consumers about their ability to opt out of an institution's overdraft service without being considered to be promoting the service. As a result, limiting the rule to institutions that market the service may have had the unintended consequence of discouraging transparency by depository institutions regarding their overdraft payment practices.

In addition, available data indicate that the percentage of accountholders with one or more overdrafts paid during a calendar year appears to be consistent across institutions, whether or not an institution promotes its overdraft service. Thus, a significant number of consumers who use overdraft services on a regular basis may not receive the benefit of the aggregate fee disclosures which might otherwise enable them to consider their approach to account management and determine whether other types of accounts or services would be more appropriate for their needs.

Summary of Proposed Revisions. The proposal would require all institutions to provide aggregate dollar amount totals of fees for paying overdrafts and fees for returning items unpaid on periodic statements provided to consumers. Because staff's review of current periodic statement disclosures for institutions that promote overdraft services indicates the aggregate fee totals are often ineffectively disclosed, the proposal would also impose additional format requirements with respect to the aggregate fee disclosures. Staff also anticipates conducting consumer testing on the fee disclosures following issuance of the proposal.

3. Disclosure of Deposit Account Balances

Background. TISA § 263(e) prohibits misleading or inaccurate advertisements, announcements, or solicitations. The February 2005 Overdraft Guidance recommended as a best practice that, when consumers make a balance inquiry, institutions disclose the actual account balance without including any funds the institution may provide to cover an overdraft item because including such funds may cause consumers to overdraw their accounts inadvertently and incur a fee.

Summary of Proposed Revisions. The proposal follows the 2005 Overdraft Guidance and would prohibit institutions from including in response to a balance inquiry any funds the institution may provide to cover an overdraft item. The proposal would apply to any automated system that is programmed by an institution to provide account balance information. The proposal would not apply to consumer discussions with a representative of the institution conducted in person, by telephone, or over the Internet due to concerns about the compliance burden associated with monitoring individual conversations. Institutions would be permitted, at their option, to disclose a second account balance that includes funds available for paying overdrafts, provided the institution prominently discloses at the same time that this balance includes additional funds provided by the institution to cover overdrafts.

Conclusion

Staff recommends that the Board publish for comment (1) proposed amendments to Regulation AA prohibiting certain unfair or deceptive practices in connection with credit cards and overdrafts; (2) proposed amendments to Regulation Z to provide additional consumer protections for credit card accounts and make limited revisions to the Board’s June 2007 Proposal to improve open-end credit disclosures; and (3) proposed amendments to Regulation DD to address institutions’ disclosure practices regarding overdraft services and fees. Staff requests authority to make minor and technical changes as necessary prior to issuance to assure conformance with the actions of OTS and NCUA. In the event that material changes are proposed by these other agencies, staff requests that the Board delegate authority to approve these changes to Governor Kroszner, Chairman of the Committee on Consumer and Community Affairs.