BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DIVISION OF CONSUMER AND COMMUNITY AFFAIRS

DATE: December 12, 2008

TO: Board of Governors

FROM: Governor Kroszner
Committee on Consumer and Community Affairs

SUBJECT: Final Amendments to Regulation AA (Unfair or Deceptive Acts or Practices), Regulation Z (Truth in Lending), and Regulation DD (Truth in Savings); Proposed Amendments to Regulation E (Electronic Fund Transfers)

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

A copy of the draft Federal Register notice may be obtained by contacting the Office of the Secretary on x3982 or x3315.

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SUBJECT: Final Amendments to Regulation AA (Unfair or Deceptive Acts or Practices), Regulation Z (Truth in Lending), and Regulation DD (Truth in Savings); Proposed Amendments to Regulation E (Electronic Fund Transfers)

ACTION REQUESTED: Approval to publish final amendments to Regulation AA (Unfair or Deceptive Acts or Practices), Regulation Z (Truth in Lending), and Regulation DD (Truth in Savings). Approval to publish proposed amendments to Regulation E (Electronic Fund Transfers)

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

- The final amendments to Regulation Z would revise the disclosure requirements for credit card accounts and other open-end (revolving) plans that are not home-secured. These amendments would also provide additional consumer protections for credit card accounts to complement the final amendments to Regulation AA.

- The final amendments to Regulation DD would require all depository institutions to provide periodic statement disclosures of the fees associated with overdraft services. The amendments also address the extent to which institutions may include information about overdraft funds in balances disclosed through an automated system.

- The proposed amendments to Regulation E would require financial institutions to provide consumers the right to opt out of, or alternatively opt in to, the payment of overdrafts for ATM withdrawals and one-time debit card transactions.[1] The amendments would also prohibit institutions from assessing overdraft fees caused by debit holds in certain circumstances.

SUMMARY

[*] S. Braunstein, L. Chanin, J. Michaels, D. Stein, K. Ayoub, A. Burke, D. Miller, B. Olson, K. Tran-Trong, V. Wong, J. Wood.

[1] The Regulation E proposal would be substituted for provisions addressing overdrafts that were previously proposed under Regulation AA and Regulation DD.

I. <u>Regulation AA (Unfair or Deceptive Acts or Practices)</u>

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. OTS and NCUA are adopting rules substantially similar to those recommended by Board staff. The agencies' rules would apply to depository institutions that issue credit cards, with the exception of state-chartered credit unions.[2]

Staff <u>recommends</u> amending Regulation AA to prohibit several unfair acts or practices with respect to credit card accounts:

- <u>Time to Make Payments</u>. The final rule prohibits banks from treating a payment as late for any purpose unless the bank provides a reasonable amount of time for the consumer to make that payment. The rule provides a safe harbor for banks that send periodic statements at least 21 days prior to the payment due date. The final rule is discussed in detail beginning on page 9.

- <u>Allocation of Payments</u>. When different annual percentage rates (APRs) apply to different balances on a credit card account (<u>e.g.</u>, purchases, balance transfers, cash advances), the final rule requires banks to allocate payments exceeding the minimum payment to the balance with the highest rate first or pro rata among all of the balances. These requirements apply to all balances on the account, including accounts with balances at discounted promotional rates. The final rule is discussed in detail beginning on page 12.

- <u>Increasing Interest Rates</u>. The final rule requires banks to disclose at account opening all interest rates that will apply to the account and prohibits increases in those rates, except in certain circumstances. First, if a rate disclosed at account opening expires after a specified period of time, banks may apply an increased rate that was also disclosed at account opening. Second, banks may increase a rate due to the operation of an index (<u>i.e.</u>, the rate is a variable rate). Third, after the first year, banks may increase a rate for new transactions only after complying with the 45-day advance notice requirement in Regulation Z. Fourth, banks may increase a rate if the minimum payment is received more

[2] 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 these rules.

than 30 days after the due date. The final rule is discussed in detail beginning on page 16.

- Two-Cycle Billing. The final rule prohibits institutions from calculating interest using a method referred to as "two-cycle billing." Under this method, when a consumer pays the entire account balance one month, but does not do so the following month, the bank calculates interest for the second month using the account balance for days in the previous billing cycle as well as the current cycle. The final rule is discussed in detail beginning on page 21.

- Financing of Security Deposits and Fees. The final rule addresses concerns regarding subprime credit cards with high fees and low credit limits. Banks are prohibited 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 percent of the initial credit limit. The rule also limits the security deposits and fees charged at account opening to 25 percent of the initial credit limit and requires any additional amounts (up to 50 percent) to be spread evenly over at least the next five billing cycles. The final rule is discussed in detail beginning on page 22.

- Credit Card Proposals That Are Not Adopted. Staff recommends withdrawal of two proposed provisions: (1) the provision requiring disclosures for banks making firm offers of credit advertising a range of APRs or credit limits; and (2) the provision prohibiting banks from imposing a fee when the credit limit is exceeded solely because the institution placed a "hold" on available credit. This recommendation is discussed in detail beginning on page 24.

II. Regulation Z (Truth in Lending)

The goal of the Regulation Z amendments is to improve the effectiveness of the disclosures that creditors provide to consumers at application and throughout the life of an open-end (revolving) account. The changes are the result of the Board's review of the provisions that apply to credit card accounts and open-end plans generally (other than home-secured lines). The staff recommends that the Board adopt changes to format, timing, and content requirements for the five main types of open-end credit disclosures governed by 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) advertising provisions. The staff further recommends that the Board adopt additional protections in Regulation Z to complement the Regulation AA amendments. A summary of the specific staff recommendations follows:

Applications and solicitations. The final rule contains format and content changes to make the credit and charge card application and solicitation disclosures more meaningful and easier for consumers to use. These disclosures are provided in the form of a table that summarizes the key account terms. The changes include:

- Format Revisions. New format requirements for the summary table include rules regarding type size, the use of boldface type for certain key terms, and the placement of information.

- Content Revisions. Creditors must disclose the duration that penalty rates may be in effect, simplify disclosures about variable rates, revise disclosures regarding when a grace period is offered on purchases or when no grace period is offered, and include a reference to consumer education materials on the Board's Web site.

The final rule is discussed in detail beginning on page 32.

Account-opening disclosures. The final rule enhances the cost disclosures provided at account opening to make the information more conspicuous and easier to read. The changes include:

- Summary Table. Certain key terms must be disclosed in a summary table at account opening, which is substantially similar to the table required for credit and charge card applications and solicitations.

- Disclosure of Fees. A different approach to disclosing fees is adopted to provide greater clarity for identifying fees that must be disclosed. In addition, creditors would have flexibility to disclose certain optional charges in writing or orally other than at account opening.

The final rule is discussed in detail beginning on page 35.

Periodic statement disclosures. The final rule contains revisions to make disclosures on periodic statements more understandable, primarily by making changes to the format requirements, such as by grouping fees and interest charges together. The changes include:

- Interest Charges and Fees. Interest charges and fees must be grouped separately, with a monthly total for each. Interest charges must be itemized according to the type of transaction (such as interest charged on purchases, and interest charged on cash advances). Separate year-to-date totals for fees and interest charges are also required.

- Effective APR. The requirement to disclose an "effective APR" is eliminated.

- Minimum Payment Disclosure. The effect of making only the minimum required payment on the time to repay balances must be disclosed, as required by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.

The final rule is discussed in detail beginning on page 38.

Changes in consumer's interest rate and other account terms. The final rule expands the circumstances under which consumers receive advance written notice of changes in the account terms (e.g., an increase in the interest rate), and increases the amount of time these notices must be sent before the change becomes effective. The changes include:

- Increase in Advance Notice for Changes in Terms. The final rule increases the amount of advance notice before a changed term can be imposed from 15 to 45 days to better allow consumers to obtain alternative financing or change their account usage.

- Requiring Prior Notice for Penalty Rate Increases. Creditors must provide 45 days' notice before the creditor increases a rate due to the consumer's delinquency or default or as a penalty.

- Summary Table. When a change-in-terms notice or penalty-rate notice accompanies a periodic statement, creditors must provide a tabular disclosure on the front side of the periodic statement showing the key terms being changed.

The final rule is discussed in detail beginning on page 44.

Additional protections. The final rule contains the following additional protections for consumers:

- Advertising of "Fixed" Rates. Advertisements may refer to a rate as "fixed" only if a time period is specified for which the rate is fixed and the rate will not increase for any reason during that time, or if a time period is not specified, if the rate will not increase for any reason while the plan is open.

- Cut-off Times and Due Dates for Mailed Payments. Creditors must set reasonable cut-off hours for mailed payments to be considered timely on the due date. The final rule would deem 5 p.m. to be a reasonable time. When mailed payments are not accepted on the due date, such as on weekends or holidays, creditors must consider a payment received on the next business day as timely. These provisions complement the Regulation AA provision providing consumers a reasonable amount of time to make payments.

- Definition of Open-End Credit. The final rule clarifies that advances that are separately underwritten are generally not open-end credit, but closed-end credit for which closed-end disclosures must be given.

The final rule is discussed in detail beginning on page 47.

III. Regulation DD (Truth in Savings)

Staff recommends amending Regulation DD to address depository institutions' disclosure practices related to overdrafts:

- Disclosure of Aggregate Overdraft Fees. The final rule extends 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 statement period and the year-to-date). Currently, only institutions that promote or advertise the payment of overdrafts must disclose aggregate amounts.

- Disclosure of Balance Information. The final rule requires institutions that provide account balance information through an automated system to provide a balance that excludes any additional funds that may be made available to cover overdrafts.

The final rule is discussed in detail beginning on page 50.

IV. Regulation E (Electronic Fund Transfers)

Staff recommends the issuance of proposed amendments to Regulation E to provide consumers certain protections relating to the assessment of overdraft fees. Similar proposals originally set forth under Regulations AA and DD would be withdrawn:

- Consumer Choice Regarding Overdraft Services. The proposal would solicit comment on two approaches to provide consumers a choice regarding the payment of overdrafts by their institution. Each approach is limited to the payment of overdrafts for ATM withdrawals and one-time debit card transactions. Under one approach, an institution would be prohibited from imposing an overdraft fee unless the consumer is given an initial notice and a reasonable opportunity to opt out of the payment of such overdrafts and the consumer does not opt out. The other approach would prohibit institutions from imposing a fee for paying such overdrafts unless the consumer affirmatively consents (or opts in) to the institution's overdraft service.

- Debit Holds. The proposal would prohibit institutions from imposing an overdraft fee when the account is overdrawn because of a hold placed on funds in the consumer's account that exceeds the actual transaction amount.

The proposed amendments are discussed in detail beginning on page 53.

V. Effective Dates

Staff recommends making the revisions to Regulation AA and Regulation Z effective on July 1, 2010 in light of institutions' need to extensively redesign systems and modify procedures to comply with the changes required under both regulations. Staff recommends making the revisions to Regulation DD effective on January 1, 2010.

DISCUSSION

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

Background on the FTC Act. The FTC Act prohibits unfair or deceptive acts or practices in commerce, and each of the federal banking agencies has authority to enforce this general prohibition with respect to the institutions they supervise.[3] The FTC Act also

[3] 15 U.S.C. 45(a); 12 U.S.C. 1818(b)(1), (e)(1), and (i)(2).

authorizes the issuance of rules defining particular practices that are unfair or deceptive and grants rulemaking authority to the Board with respect to banks, the OTS with respect to savings associations, and the NCUA with respect to federal credit unions.[4] The FTC is responsible for issuing rules for other persons and entities but it must follow statutorily required rulemaking procedures, including holding hearings to develop an evidentiary record.[5] Those procedures do not apply to the Board, OTS, or NCUA.

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 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.

The Proposed Rules. In May 2008, the Board, OTS, and NCUA jointly proposed rules addressing unfair or deceptive acts or practices with respect to consumer credit card accounts and overdraft services for deposit accounts. The comment period for this proposal closed on August 4, 2008. The Board received more than 60,000 comments on the proposed rules, more than for any other regulatory proposal in its history. The overwhelming majority of these comments came from individual consumers. A substantial

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[4] 15 U.S.C. 57a(f)(1).

[5] 15 U.S.C. 57a(b)-(e), (g)-(j); 15 U.S.C. 57a-3.

[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.

majority of individual consumers expressed support for the proposed rules, and many urged the Board to go further in protecting consumers. The remaining comments came from credit card issuers, community banks, trade associations, consumer groups, members of Congress, other federal banking agencies, state and local governments, and others.

In addition to reviewing the comments, staff has held meetings and discussions with consumer advocates, industry representatives, members of the Consumer Advisory Council, and other federal agencies regarding credit card practices. 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 amendments to the credit card provisions in Regulation Z.

Upon analysis of the issues and the comments received, staff recommends that the Board publish final amendments to Regulation AA regarding unfair credit card practices. Staff also recommends the Board withdraw the proposed rules regarding overdraft services and instead issue a new proposal addressing these issues under Regulation E.

Discussion

1. Providing Consumers Adequate Time to Make Payments

Background. Many credit card issuers have reduced the amount of time provided to consumers to make payment while increasing the costs imposed on consumers whose payments are not received by the due date (such as late payment fees and penalty interest rates). In response to its June 2007 Regulation Z Proposal, the Board received comments from individual consumers, consumer groups, and a member of Congress, stating that, because of the time required for mailed periodic statements to reach consumers and for consumers' mailed payments to reach creditors, consumers' payments are sometimes received after the due date, leading to late fees, rate increases, finance charges as a result of loss of the grace period, and other adverse consequences. Industry commenters, however, generally stated that consumers currently receive ample time to make payment, particularly in light of the increasing number of consumers who receive periodic statements electronically and make payments electronically or by telephone.

Proposal. In May 2008, the Board concluded that a bank's failure to provide consumers with a reasonable amount of time to make payment appeared to cause unavoidable injury to consumers that outweighed any countervailing benefits. Accordingly, the Board proposed to prohibit banks 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 did not mandate a specific amount of time, it provided a safe harbor for banks that adopt 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 have allowed 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 bank by mail.

Comments. Comments on the proposed rule generally focused on the 21-day safe harbor. Individual consumers, consumer groups, members of Congress, the FDIC, and two state attorneys general supported the proposed rule, although some argued that the safe harbor should be extended to 28 or 30 days. In contrast, although some industry commenters stated that they currently mail or deliver periodic statements 21 days in advance of the due date, most argued that 21 days was excessive and requested a safe harbor ranging between 13 and 19 days.

Industry commenters raised three primary objections to the proposed safe harbor. First, they argued that allowing seven days for delivery of a periodic statement is unnecessary because, in most cases, statements are delivered two to four days after mailing. However, while seven days may be more time than is needed for most consumers to receive a periodic statement by mail, a safe harbor based solely on average mailing times would not adequately protect consumers whose delivery times are longer than average (e.g., consumers who live in rural areas).

Second, industry commenters argued that allowing seven days for delivery of statements is excessive because many consumers receive their statements electronically and make payment electronically or by telephone. In addition, some larger institutions reported that less than half of their consumers use mail to submit payments. However, one industry trade association reported that 70 to 80 percent of community bank customers mail their payments. Thus, a safe harbor based on the assumption that consumers use alternative means to receive statements or make payments would not protect a significant number of consumers.

Third, industry commenters argued that the time required to generate and mail periodic statements would make it difficult to comply with the safe harbor in shorter months (such as February). However, staff believes that this difficulty does not warrant a general reduction in the protections for consumers.

Recommendation. Staff recommends adopting the proposed rule prohibiting banks from treating a payment as late for any purpose unless consumers have been provided a reasonable amount of time to make payment. Staff believes that a 21-day safe harbor is appropriate to ensure that consumers have sufficient time to review their periodic statements before making payment.

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. In order to avoid any potential conflict with this statutory requirement, the final rule permits a bank 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. Credit card issuers generally allocate payments first to the balance with the lowest interest rate, which maximizes the assessment of interest charges if the consumer does not pay the balance in full each month. This practice is particularly disadvantageous for consumers who 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.

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 makes a payment of $800 intending to pay off the purchase and cash advance balances, almost all credit card issuers would apply the entire payment to the promotional rate balance so that the consumer will incur interest charges on the more costly cash advance and purchase balances.[8]

Staff conducted extensive consumer testing during the Regulation Z review to develop disclosures that would explain payment allocation methods and enable consumers to make informed decisions about card usage, particularly in regard to promotional rates. 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, disclosures generally did not enable consumers who were unfamiliar with payment allocation to understand its effects. Thus, disclosures alone do not appear to enable consumers to avoid the higher interest charges caused by current payment allocation practices. Furthermore, even if disclosures were effective, consumers still could not avoid higher interest charges by selecting a credit card account with more favorable terms because issuers almost uniformly apply payments first to the balance with the lowest rate.

Proposal. In May 2008, the Board stated that the allocation of payments first to the balance with the lowest interest rate appeared to cause unavoidable injury to consumers that outweighed any countervailing benefits. Accordingly, the Board proposed a general

[8] As a result, consumers who take a cash advance, which usually carries the highest rate applicable to the account, are unable to pay down that balance until all other balances are paid in full.

rule governing payment allocation as well as special rules for accounts with promotional rate balances or balances on which interest is deferred.[9]

The general rule would have required banks to allocate an amount paid by the consumer in excess of the minimum payment (excess payment) among the different balances using one of three methods or another method that is no less beneficial to the consumer. The specified methods were: (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).

The proposed rule would also have established separate allocation requirements for accounts with promotional rate balances or deferred interest balances. For these accounts, an excess payment would be applied to promotional rate balances or deferred interest balances only if all other balances have been paid in full. In addition, the proposal would have prohibited banks from requiring consumers who are otherwise eligible for a grace period on purchases 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.

Comments. The Board received comments in support of the proposed rule from individual consumers, consumer groups, members of Congress, the FDIC, two state attorneys general, and a state consumer protection agency. However, many of these commenters criticized the proposal as overly complex, stating that, because disclosure does

[9] Many creditors offer deferred interest plans where consumers may avoid paying interest on purchases if the balance is paid in full by the end of the deferred interest period. However, if the balance is not paid in full when that period ends, these plans charge all interest that has accrued at a specified annual percentage rate during the period in a lump sum.

not enable consumers to understand payment allocation practices, allowing institutions to use a variety of methods will not improve transparency. Instead, they urged the Board to require that excess payments be applied first to the balance with the highest rate in all circumstances, thereby minimizing interest charges. Credit card issuers and industry groups strongly opposed the proposal, stating that it would be operationally burdensome to implement and that any harm to consumers would be better addressed through disclosure. In addition, these commenters argued that the special rules regarding promotional rate and deferred interest balances would ultimately harm consumers by reducing or eliminating promotional rate and deferred interest offers.

Data provided by industry indicates that 16 to 19 percent of active accounts have one or more promotional rate balances and that the average promotional rate on those balances is approximately 13 percentage points lower than the average non-promotional rate. This data further indicates that, when rates are weighted to account for the proportion of the total balance that is at a promotional rate, the effective annual percentage rate is approximately 10 percentage points lower than the average rate for non-promotional balances. Thus, it appears that discounted promotional rates can result in significantly lower interest charges for some consumers.

Recommendation. Because disclosure does not appear to enable consumers to make informed comparisons of payment allocation methods, staff recommends revising the proposed general rule governing payment allocation to permit only two methods: allocation of payments to the highest rate balance first and pro rata allocation. The proposed method allowing allocation of equal portions to each balance has been removed to reduce complexity. In addition, because it appears that consumers generally have approximately 25 percent of their total balance at a discounted promotional rate, the equal share method would generally be less beneficial to consumers than the pro rata method because – unless the account has four or more balances – the equal share method would generally apply more of the excess payment to the discounted promotional rate balance than the pro rata method.

Staff expects that under the draft final rule, most institutions will use the pro rata method, which will focus competition on more transparent costs of credit (such as interest rates). The revised rule may reduce interest revenue and result in somewhat higher rates and fees to offset this. Nevertheless, staff believes it will increase transparency and enable consumers to better understand the costs associated with using their credit card accounts at the time they engage in transactions.

Staff also recommends that, rather than adopting the special rules allocating payments to promotional rate and deferred interest balances last, the final rule should apply the same general payment allocation rule to all balances. In addition to simplifying the final rule, staff believes this change will significantly limit the impact of the final rule on the availability of discounted promotional rates that benefit consumers.

3. <u>Increasing Interest Rates</u>

<u>Background</u>. An increase in the interest rate that applies to a credit card account can come as a costly surprise to consumers who relied on the rate in effect at the time they opened the account or engaged in transactions. This practice, which is sometimes referred to as "repricing," occurs in several circumstances. Credit card issuers generally impose penalty rates that can be more than twice the consumer's normal rate on purchases when, for example, a payment is late. Similar increases can be imposed based on factors not

directly related to the account (such as a drop in credit score or a default on a different account), a practice that is sometimes referred to as "universal default." In addition, issuers typically reserve the right to increase rates on existing balances at any time, for any reason (e.g., to reflect changes in the creditor's cost of funds).

In response to concerns about the repricing of outstanding balances, the Board's June 2007 Regulation Z Proposal included a requirement that creditors provide 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.[10] In response, individual consumers, consumer groups, the OCC, and a member of Congress provided comments asserting 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.

Proposal. In May 2008, the Board stated that increasing the rate on an outstanding balance appeared to cause unavoidable injury to consumers that outweighed any countervailing benefits. Accordingly, the Board proposed to prohibit banks from increasing the interest rate applicable to an outstanding balance on a consumer credit card 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 bank does not increase the rate to the penalty rate; and (3) when the minimum payment has not been received within

[10] This proposal is discussed in greater detail beginning on page 44.

30 days of the due date. The proposed rule did not, however, place any limitations on banks' ability to increase rates for future transactions.

The Board was also concerned that these protections would be ineffective if consumers were not provided a reasonable amount of time to pay off outstanding balances that could not be repriced. Accordingly, the proposed rules would limit card issuers' ability to accelerate repayment. Under the proposal, creditors could establish an amortization period of five years or more, double the consumer's repayment rate, or use a repayment schedule that is no less beneficial than the two specified methods. Finally, in order to prevent banks from assessing fees or other charges as a substitute for an increase in the interest rate, the Board proposed to prohibit such assessments based solely on the balance that cannot be repriced.

Comments. This proposal received strong support from individual consumers, consumer groups, members of Congress, the FDIC, two state attorneys general, and a state consumer protection agency. Many of these commenters urged the Board to go further, by eliminating all but the exception for variable rates, applying the prohibition to rate increases on future transactions, and prohibiting institutions from assessing deferred interest on past transactions. In contrast, the proposal received strong opposition from credit card issuers, industry groups, and the OCC, who argued that the proposed restrictions would undermine banks' ability to price according to current market conditions and the risk presented by individual consumers and would, therefore, result in significantly higher costs or reduced credit availability for all consumers. These commenters requested, among other things, that the Board adopt additional exceptions to allow greater flexibility in creditors' ability to reprice outstanding balances.

Recommendation. Staff recommends revising the proposed rule to require institutions to disclose at account opening all interest rates that will apply to the account and to prohibit increases in those rates (unless an exception applies). The Board's consumer testing indicated that interest rates are a primary concern for consumers when shopping for credit cards. Accordingly, when a consumer opens an account based on the rate or rates stated by the card issuer, staff believes that the consumer should be able to rely on those rates when engaging in transactions.

Staff also recommends revising the exceptions to the proposed rule. First, if a rate disclosed at account opening expires after a specified period of time, institutions would be permitted to apply an increased rate that was also disclosed at account opening. Second, as proposed, institutions would be permitted to increase a variable rate due to an increase in the index. Third, institutions would be permitted to increase a rate for new transactions only after complying with the 45-day advance notice requirement in Regulation Z (although this exception would not permit increases during the first year after the account is opened). Fourth, institutions would be permitted to increase a rate if the account becomes more than 30 days' delinquent.

Staff believes these exceptions will allow issuers sufficient flexibility while protecting consumers from unfair surprise. For example, under the draft final rule, an issuer could offer a consumer credit card account with the following annual percentage rates for purchases: a 5% non-variable rate for the first six months; a 10% non-variable rate for the next six months; and thereafter a variable rate that is currently 15%. The issuer must disclose these terms to the consumer in advance so the consumer can decide whether to accept the offer and how to use the card. If the consumer opens an account and makes a

$1,000 purchase in the first month, the issuer must apply the 5% non-variable rate to that purchase (and any additional purchases) until the end of month six. At that point, the issuer would be permitted to increase the rate that applies to the existing balance and any other purchases to the previously-disclosed 10% non-variable rate. The issuer must apply that 10% non-variable rate to all purchases until the end of month twelve. Finally, after month twelve, the issuer is permitted to apply the previously-disclosed variable rate (which, because it varies with an index, may no longer be 15%) to all purchases made during the first year. This rate may not thereafter be increased on those purchases (unless the index changes or the consumer becomes more than 30 days' delinquent). However, the issuer may establish a different rate for purchases made after the first year by providing a change in terms notice 45 days before the increased rate becomes effective.

Staff also recommends adopting the proposed rules governing the repayment of balances on which the rate cannot be increased. With these revisions, staff believes the draft final rule strikes the appropriate balance between increasing certainty and transparency in the cost of credit for consumers and allowing issuers sufficient flexibility to adjust to changes in market conditions. In addition to protecting consumers from unexpected increases in the cost of transactions that have already been completed, this rule will enable consumers to more accurately assess the cost of using their credit card accounts at the time they engage in new transactions, particularly during the first year after account opening. Finally, competition will be enhanced because issuers that offer rates that realistically reflect risk and market conditions will no longer be forced to compete with issuers offering artificially reduced rates that can increase unexpectedly.

Finally, staff recommends deleting the proposed exception allowing for repricing of existing balances when promotional rates are lost for any reason. Consumer groups criticized this exception, stating that it would continue to allow so-called “hair trigger” repricing because it placed no limitations on the circumstances in which a promotional rate could be lost. They stated that, in these circumstances, repricing is particularly harmful because issuers use discounted promotional rates to encourage consumers to make purchases they might not otherwise make. As illustrated in the above example, removal of this exception would not prevent issuers from offering discounted promotional rates. Instead, issuers would only be prevented from repricing those rates prior to expiration (unless the consumer becomes more than 30 days’ delinquent).

4. <u>Computing Interest on Account Balances Over Two Billing Cycles</u>

<u>Background</u>. Comments from individual consumers, consumer groups, and members of Congress in response to the June 2007 Regulation Z Proposal urged the Board to prohibit the balance computation method sometimes referred to as “two-cycle billing.” This method can have several permutations but, in general, 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 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.

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.

Proposal. In May 2008, the Board stated that the two-cycle method appeared to cause unavoidable injury to consumers that outweighed any countervailing benefits. Accordingly, the Board proposed to ban this practice.

Comments. Commenters generally supported the proposed ban.

Recommendation. Staff recommends that the final rule ban the two-cycle method.

5. Security Deposits and Fees That Limit Credit Availability

Background. Subprime credit cards often charge to the account considerable security deposits or fees for the issuance or availability of credit, which substantially reduce the consumer's available credit for purchases or other transactions. For example, some subprime credit cards offer a $300 credit line with $250 in upfront fees, leaving the consumer with only $50 in available credit at account opening. As discussed below beginning on page 34, the Board's proposals under Regulation Z would have required that subprime credit card solicitations disclose the amount of credit that will be available at account opening if the consumer receives the minimum credit limit and that at account opening issuers provide consumers a reasonable opportunity to cancel those accounts without penalty. However, individual consumers, consumer groups, and one member of Congress argued that substantive limitations on fees imposed for subprime credit cards are needed to protect vulnerable consumers that do not qualify for other, less-costly products.

Proposal. In May 2008, the Board stated that certain practices related to the financing of security deposits and fees for the issuance or availability of credit appear to cause unavoidable injury to consumers that outweigh any countervailing benefits. Accordingly, the Board proposed to prohibit banks 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 Board also proposed to prohibit banks from financing security deposits and fees exceeding 25 percent of the initial credit limit in the first billing cycle. Banks would have been required to spread amounts that exceed this threshold equally over the eleven billing cycles following the initial billing cycle. The proposal did not place any restrictions on security deposits and fees that are paid from separate funds.

Comments. Consumer groups, the OCC, the FDIC, and many credit card issuers supported the proposal. Some consumer groups argued that the amounts charged to the account should be limited to 10 or 25 percent of the initial credit limit. In contrast, credit card issuers who specialize in subprime cards strongly opposed the proposal, arguing that these products enable consumers who do not qualify for lower-cost credit to rebuild their credit history and that the high fees and low initial credit are necessary to offset the high risk of default among subprime consumers. The Board also received comments from thousands of individual consumers, several members of Congress, and others expressing concern that the proposed rules would restrict access to credit for consumers who do not qualify for lower-cost products.

Recommendation. Staff recommends adopting the proposed prohibition on financing security deposits and fees that, in the aggregate, constitute a majority of the initial credit limit in the first year. Staff also recommends adopting the proposed prohibition on charging at account opening security deposits and fees that exceed 25 percent of the initial credit limit. These restrictions are appropriate to protect vulnerable subprime consumers from products that charge high fees and provide little available credit. Because, however, subprime consumers do present a greater risk of default, staff recommends that the final rule permit institutions to spread security deposits and fees in excess of 25 percent of the initial credit limit (up to 50 percent) over the first six months rather than over the first year (as proposed). This change will allow subprime credit card issuers some additional flexibility to limit the amount of credit they extend until the consumer has established a payment history with that issuer.

6. Recommendation to Withdraw Additional Proposals

In May 2008, the Board issued two proposals that staff recommends be withdrawn. First, the Board proposed to require disclosure of the criteria a bank will use to determine whether consumers will receive the lowest rate and highest credit limit. This proposal was intended to address concerns that consumers who receive firm offers of credit stating a range of annual percentage rates or credit limits may believe that they will obtain the lowest rate and highest credit limit stated in the offer. However, consumer testing indicates that any consumer confusion is adequately addressed by the disclosure requirements under Regulation Z. Accordingly, staff recommends that this proposal be withdrawn.

Second, the Board proposed to prohibit banks from charging an overlimit fee when the consumer exceeded the credit limit solely because of a credit hold that exceeds the actual amount of the transaction. This proposal was intended to parallel the Board's proposal regarding debit holds. As discussed in greater detail on page 59, staff is recommending that debit holds be addressed using the Board's authority under the Electronic Funds Transfer Act (EFTA) and Regulation E. However, a separate prohibition with respect to credit holds does not appear to be warranted because credit holds do not appear to result in a significant amount of consumer harm. Accordingly, staff recommends that this proposal be withdrawn.

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.

June 2007 Proposal. The Board published proposed amendments to Regulation Z's rules for credit card accounts and other open-end credit plans that are not home-secured in June 2007. The goal of the proposal was to improve the effectiveness of the disclosures that creditors provide to consumers at application and throughout the life of the account, such as at account opening, on periodic statements, and when terms change. In developing the proposal, the staff worked with a testing consultant to conduct consumer research and considered comments received on two earlier Board-issued advance notices of proposed rulemakings (ANPRs).[11]

The proposal contained changes to format, timing, and content requirements for the five main types of open-end credit disclosures governed by Regulation Z: (1) credit and charge card application and solicitation disclosures; (2) account-opening disclosures; (3) periodic statement disclosures; (4) change-in-terms and penalty-rate notices; and (5) advertising provisions. The June 2007 Proposal also included provisions to implement amendments to TILA enacted by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the Bankruptcy Act).

The Board received over 2,500 comments on the June 2007 Proposal. About 85 percent of these were from consumers and consumer groups, and of those, nearly all were

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[11] ANPRs are published to obtain preliminary information prior to issuing a proposed rule or, in some cases, deciding whether to issue a proposed rule. The Board published ANPRs in December 2004 and October 2005.

from individuals. Of the remaining industry comments, the vast majority were from credit unions or their trade associations, whose comments focused primarily on a proposed revision to the definition of open-end credit that could affect how many credit unions currently structure their consumer loan products.

In general, commenters generally supported the June 2007 Proposal and the Board's use of consumer testing to develop revisions to disclosure requirements. 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. They also opposed the Board's proposal to require creditors to provide at least 45 days' advance notice before certain key terms change or interest rates are increased due to default or delinquency. Consumer groups opposed the Board's proposed alternative that would eliminate the effective annual percentage rate (effective APR) as a periodic statement disclosure. Consumers and consumer groups also believed the Board's proposal was too limited in scope and urged the Board to provide more substantive protections and prohibit certain card issuer practices. The comments on specific proposed revisions are discussed in more detail below.

May 2008 Proposal. In May 2008, the Board published revisions to several of the disclosures contained in the June 2007 Proposal (May 2008 Regulation Z Proposal). In developing these revisions, Board staff considered comments received on the June 2007 Proposal and worked with a testing consultant to conduct additional consumer research. The May 2008 Regulation Z Proposal also contained proposed amendments to Regulation Z that complemented the Board's Regulation AA Proposal prohibiting specific unfair acts or practices with respect to consumer credit card accounts.

The Board received over 450 comments on the May 2008 Regulation Z Proposal. About 90 percent of these were from consumers and consumer groups, and of those, nearly all were from individuals. Six comments were from government officials or organizations, and the remaining comments were from industry, including financial institutions or their trade associations and payment system networks.

Commenters generally supported the May 2008 Regulation Z Proposal, although like the June 2007 Proposal, some commenters opposed particular aspects of the proposal. For example, operational concerns and costs for system changes were cited by industry representatives who opposed the proposed limitations on when creditors may consider mailed payments to be untimely. Comments on the specific proposed provisions are discussed in more detail below.

Consumer Testing.

Developing the June 2007 Proposal. A principal goal for the review of the Regulation Z for open-end credit has been to produce improved credit card disclosures that consumers will be more likely to pay attention to, understand, and use in their decisions, while at the same time not creating undue burdens for creditors. In April 2006, the Board retained a research and consulting firm that specializes in designing and testing documents, Macro International (Macro), to assist the staff in its review of Regulation Z's credit card rules. Specifically, the Board used consumer testing to develop for the June 2007 Proposal model forms for the following credit card disclosures required by Regulation Z:

- Summary table disclosures provided in direct-mail solicitations and applications;
- Disclosures provided at account opening;
- Periodic statement disclosures; and

- Subsequent disclosures, such as notices provided when key account terms are changed, and notices on checks provided to access credit card accounts.

Board staff first worked with Macro to conduct research to learn what information consumers currently use in making decisions about their credit card accounts, and how they currently use disclosures that are provided to them. In May and June 2006, Macro conducted two sets of focus groups with credit card consumers. Through these focus groups, Board staff gathered information on what credit terms consumers usually consider when shopping for a credit card, what information they find useful when they receive a new credit card, and what information they find useful on periodic statements.

In August 2006, staff worked with Macro to conduct one-on-one discussions with credit card account holders. Consumers were asked to view existing sample credit card disclosures. The goals of these interviews were: (1) to learn more about what information consumers read when they receive current credit card disclosures; (2) to research how easily consumers can find various pieces of information in these disclosures; and (3) to test consumers' understanding of certain credit card-related words and phrases.

In late 2006 and early 2007, staff worked with Macro to develop and test sample credit card disclosures, taking into account information learned through the focus groups and the one-on-one interviews. Four rounds of interviews (seven to nine participants per round) were conducted sequentially to allow for revisions to the testing materials based on what was learned from the testing during each previous round. In each round, consumers were asked to view the sample credit card disclosures. Several of the model forms contained in the June 2007 Proposal were developed through the testing. A report summarizing the results of the testing is available on the Board's public Web site (May 2007 Macro Report).[12]

Developing the May 2008 Proposal. In early 2008, staff worked with Macro to revise the model disclosures published in the June 2007 Proposal in response to comments received. In March 2008, Macro conducted an additional round of one-on-one interviews to test revised disclosures for applications and solicitations, periodic statements, with checks that access a credit card account.

Testing conducted after May 2008. After reviewing the comments received on the May 2008 Regulation Z Proposal, staff worked with Macro in July and August 2008 to conduct two additional rounds of one-on-one interviews. Macro will also issue a report summarizing these test results, and the March 2008 test results, and this report will be available on the Board's public Web site along with the Regulation Z final rule. [13]

Subsequently, in September 2008, staff worked with Macro to develop a survey to conduct quantitative testing. The goal of the quantitative testing was to measure consumers' comprehension and the usability of the newly-developed disclosures relative to existing disclosures and formats, using a broader number of consumers. In total, Macro conducted tests with over 1,000 consumers nationwide. Macro's report on the quantitative testing results will be available on the Board's public web site.[14]

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12 Design and Testing of Effective Truth in Lending Disclosures, Macro International, May 16, 2007.

13 Design and Testing of Effective Truth in Lending Disclosures: Findings from Qualitative Consumer Research, Macro International, December 15, 2008.

14 Design and Testing of Effective Truth in Lending Disclosures: Findings from Experimental Study, Macro International, December 15, 2008.

Discussion

The goal of the revisions in this draft final rule is to improve the effectiveness of the Regulation Z disclosures that must be provided to consumers for open-end accounts. For credit card accounts, a summary of the key account terms must accompany applications and solicitations. For all open-end credit plans, creditors must disclose costs and terms at account opening, generally before the first transaction. Consumers must receive periodic statements of account activity, and creditors must provide notice before certain changes in the account terms may become effective.

To shop for and understand the cost of credit, consumers must be able to identify and understand the key terms of open-end accounts. The terms and conditions that impact credit card account pricing can be complex, however. The revisions to Regulation Z are intended to provide the most essential information to consumers when the information would be most useful to them, with content and formats that are clear and conspicuous. The revisions are expected to improve consumers' ability to make informed credit decisions and enhance competition among credit card issuers. Many of the changes are based on consumer testing that was conducted in connection with the Regulation Z review.

In considering the final revisions, staff has also sought to balance the potential benefits for consumers with the compliance burdens imposed on creditors. For example, the revisions seek to provide greater certainty to creditors in identifying what costs must be disclosed for open-end plans, and when those costs must be disclosed. Staff is also recommending that the Board adopt the proposed rule that fees and interest charges must be grouped on periodic statements, but withdraw from the final rule proposed requirements for additional formatting changes to the periodic statement, such as the grouping of transactions, for which the burden to creditors may exceed the benefit to consumers. More effective disclosures may also reduce customer confusion and misunderstanding, which may also ease creditors' costs relating to consumer complaints and inquiries.

This section of the memorandum is intended to provide an overview of the key recommendations regarding the disclosures and protections set forth in the draft final rule. The draft final rule also contains a number of additional revisions to existing disclosures and adds new substantive protections regarding, among other things, convenience checks, error resolution procedures and debt suspension coverage. These additional provisions are discussed in detail in the supplementary information accompanying the draft final rule.

1. Credit Card Applications and Solicitations

Background. Under Regulation Z, credit and charge card issuers are required to provide information about key costs and terms with their applications and solicitations.[15] This information is abbreviated to help consumers focus on only the most important terms and decide whether to apply for the credit card account. The application and solicitation disclosures are considered among the most effective TILA disclosures principally because they must be presented in a standardized table with headings, content, and format substantially similar to the model forms published by the Board.

Proposal. The proposal added new format requirements for the summary table,[16] including rules regarding type size and use of boldface type for certain key terms, and the placement of information. Creditors would also be required to describe the actions that may trigger the penalty APR (such as a late payment) in the summary table. Content

[15] Charge cards are a type of credit card for which full payment is typically expected upon receipt of the billing statement. To ease discussion, this memorandum will refer simply to "credit cards."

[16] This table is commonly referred to as the "Schumer box."

revisions included a requirement that creditors disclose the duration that penalty rates may be in effect, a shorter disclosure about variable rates, new disclosures highlighting the effect of creditors' payment allocation practices, and a reference to consumer education materials available on the Board's Web site.

Recommendations.

Penalty pricing. The draft final rule makes several revisions that seek to improve consumers' understanding of default or penalty pricing. Currently, credit card issuers must disclose inside the table the APR that will apply in the event of the consumer's "default." Some creditors define a "default" as making one late payment or exceeding the credit limit once. The actions that may trigger the penalty APR are currently required to be disclosed outside the table.

However, consumer testing indicated that many consumers did not notice the information about penalty pricing when it was disclosed outside the table. Under the draft final rule, card issuers must include in the table the specific actions that trigger penalty APRs, the rate that will apply, and the circumstances under which the penalty rate will expire or, if true, the fact that the penalty rate could apply indefinitely.[17] The regulation requires card issuers to use the term "penalty APR" because the testing demonstrated that some consumers are confused by the term "default rate."

Similarly, the draft final rule requires card issuers to disclose inside (rather than outside) the table the fees for paying late, exceeding a credit limit, or making a payment that is returned. Cash advance fees and balance transfer fees also must be disclosed inside

[17] The draft final rule does not require a creditor to distinguish, in the disclosures given with an application or solicitation or at account opening, between those penalty rate triggers that apply to existing balances and more general contractual penalty triggers that may apply only to new balances. However, a consumer would receive a change-in-terms notice or a penalty-rate notice informing the consumer whether a specific rate increase is applied to existing balances or to new balances.

the table. This change is based on consumer testing results; fees disclosed outside the table were often not noticed. The disclosure of returned-payment fees and fees for required credit insurance, debt suspension or cancellation coverage, and foreign currency transactions are new requirements.

Variable-rate information. Currently, applications and solicitations offering variable APRs must disclose inside the table the index or formula used to make adjustments and the amount of any margin that is added. Additional details, such as how often the rate may change, must be disclosed outside the table. Under the draft final rule, information about variable APRs is reduced to a single phrase indicating the APR varies "with the market," along with a reference to the type of index, such as "Prime." Consumer testing indicated that few consumers use the variable-rate information when shopping for a card. Moreover, participants were distracted or confused by details about margin values, how often the rate may change, and where an index can be found.

Subprime accounts. Consumer complaints received by the federal banking agencies state that when consumers applied for subprime credit cards they were unaware of how little credit would be available after all the fees were assessed at account opening. The draft final rule requires additional disclosures if the creditor requires fees or a security deposit to issue the card that are 15 percent or more of the minimum credit limit offered for the account. In such cases, the card issuer is required to include an example in the table of the amount of available credit the consumer would have after paying the fees or security deposit, assuming the consumer receives the minimum credit limit.[18]

[18] The draft final Regulation Z rule also requires issuers to provide consumers at account opening, notice about the right to reject a plan when fees have been charged but the consumer has not used the plan.

Description of grace period. The draft final rule requires card issuers to use the heading "How to Avoid Paying Interest on Purchases" on the row describing a grace period offered on all purchases, and the phrase "Paying Interest" if a grace period is not offered on all purchases. Consumer testing indicates consumers do not understand the term "grace period" as a description of actions consumers must take to avoid paying interest.

Payment allocation. In light of the recommendation to adopt substantive requirements regarding payment allocation under Regulation AA, staff recommends that the Board not adopt the proposed disclosures explaining payment allocation methods in the table. Testing indicated that most consumers do not understand how payment allocation works and the tested disclosures did not aid consumers' understanding.

2. Account-Opening Disclosures

Regulation Z requires creditors to disclose costs and terms before the first transaction is made on the account. The disclosures must specify the circumstances under which a "finance charge" may be imposed and how it will be determined. A "finance charge" is any charge that may be imposed as a condition of or an incident to the extension of credit, and includes, for example, interest, transaction charges, and minimum charges. The finance charge disclosures include a disclosure of each periodic rate of interest that may be applied to an outstanding balance (e.g., purchases, cash advances) as well as the corresponding APR. Creditors must also explain any grace period for making a payment without incurring a finance charge and consumers' rights and responsibilities in the case of unauthorized use or billing disputes. In addition, they must disclose the amount of any charge other than a finance charge that may be imposed as part of the credit plan ("other charges"), such as a late-payment charge. Currently, there are few format requirements for these account-opening disclosures, which are typically interspersed among other contractual terms in the account agreement.

Proposal. The Board proposed to require certain key terms to be disclosed in a summary table at account opening, which would be substantially similar to the table required for applications and solicitations. A different approach to disclosing fees was proposed, including providing creditors with flexibility to disclose certain charges (other than those in the summary table) in writing or orally after the account is opened, but before the charge is imposed.

Recommendations.

Account-opening summary table. Account-opening disclosures have often been criticized because the key terms TILA requires to be disclosed are often interspersed within the credit agreements, and such agreements are long and complex. To address this concern and make the information more conspicuous, the draft final rule requires creditors to provide at account opening a table summarizing the key terms. Creditors may continue, however, to provide other account-opening disclosures, aside from the fees and terms specified in the table, in their account agreements.

The new table required at account opening is substantially similar to the table provided with direct-mail credit card applications and solicitations. Consumer testing indicates that consumers generally are aware of the table on applications and solicitations. Consumer testing also indicates that consumers typically do not read their account agreements, which are often in small print and dense prose. Thus, setting apart the key terms in a summary table will better ensure that consumers are aware of those terms.

The table required at account opening includes more information than the table required at application. For example, it includes a disclosure whether or not there is a grace period for all features of an account. For subprime credit cards, to give consumers the opportunity to avoid fees, the draft final rule also requires issuers to provide consumers at account opening, notice about the right to reject a plan when fees have been charged but the consumer has not used the plan. However, to reduce compliance burden for creditors that provide the complete account-opening disclosures at application, the draft final rule allows creditors to provide the more specific and inclusive account-opening table with the application in lieu of the table otherwise required at application.

<u>How charges are disclosed</u>. Under the current rules, a creditor must disclose any "finance charge" or "other charge" in the account-opening disclosures, and a subsequent notice is required if one of these fees increases or if certain fees are newly introduced during the life of the plan. As creditors develop new kinds of services, some find it difficult to determine if associated charges for the new services meet the standard for a "finance charge" or "other charge" or are not covered by TILA at all. This uncertainty can pose legal risks for creditors that act in good faith to comply with the law, so the consequences of an error can be significant.

The fee disclosure rules also have been criticized as being outdated. These rules require creditors to provide fee disclosures at account opening, which may be months, and possibly years, before a particular disclosure is relevant to the consumer, such as when the consumer requests a service for which a fee is imposed. In addition, an account-related transaction may occur by telephone, when a written disclosure is not feasible.

The draft final rule is intended to respond to these criticisms while still giving full effect to TILA's requirement to disclose credit charges before they are imposed. Accordingly, the rules are revised to (1) specify the charges that creditors must disclose in writing at account opening (such as interest, transaction fees, annual fees, and late payment penalty fees), which must be listed in the summary table; and (2) permit creditors to disclose other less critical charges orally or in writing before the consumer agrees to or becomes obligated to pay the charge. Although the draft final rule permits creditors to disclose certain costs orally for purposes of TILA, staff anticipates that creditors will continue to identify fees in the account agreement for contract or other reasons.

3. Periodic Statements

Creditors are required to provide periodic statements reflecting the account activity for the billing cycle (typically, about one month). In addition to identifying each transaction on the account, creditors must identify each "finance charge" using that term, and each "other charge" assessed against the account during the statement period. When a periodic interest rate is applied to an outstanding balance to compute the finance charge, creditors must disclose each periodic rate and its corresponding APR. Creditors must also disclose an "effective" or "historical" APR for the billing cycle, which, unlike the corresponding APR, includes not just interest but also finance charges imposed in the form of fees (such as cash advance fees or balance transfer fees). Periodic statements must also state the time period a consumer has to pay an outstanding balance to avoid additional finance charges ("grace period"), if applicable.

Proposal. Interest charges for different types of transactions, such as purchases and cash advances would be itemized, and separate totals of fees and interest for the month and year-to-date would be disclosed. The proposal offered two approaches regarding the effective APR: one modified the format and terminology for disclosing the effective APR, and the other solicited comment on whether the requirement to disclose this rate should be eliminated. To implement changes required by the Bankruptcy Act, the proposal required creditors to explain the effect of making only the minimum required payment on the repayment of balances.

<u>Recommendations</u>.

<u>Fees and interest costs</u>. The draft final rule contains a number of revisions to the periodic statement to improve consumers' understanding of fees and interest costs. Currently, creditors must identify on periodic statements any "finance charges" added to the account during the billing cycle, and creditors typically intersperse these charges with other transactions (such as purchases) in a chronological list. Charges such as late payment fees, which are not "finance charges," are typically disclosed individually and are interspersed among other transactions.

Consumer testing indicated that consumers generally understand that "interest" is the cost that results from applying a rate to a balance over time and distinguish "interest" from other fees, such as a cash advance fee or a late payment fee. Consumer testing also indicated that many consumers more easily determine the number and amount of fees when the fees are itemized and grouped together.

Thus, under the draft final rule, creditors are required to group all charges together and describe them in a manner consistent with consumers' general understanding of costs ("interest charge" or "fee"), without regard to whether the charges are considered "finance charges," "other charges," or neither. Interest charges must be identified by type (for example, interest on purchases or interest on balance transfers) as must fees (for example, cash advance fee or late-payment fee).

Consumer testing also indicated that many consumers more quickly and accurately determined the total dollar cost of credit for the billing cycle when a total dollar amount of fees for the cycle was disclosed. Thus, the draft final rule requires creditors to disclose the (1) total fees; and (2) total interest imposed for the cycle. Creditors must also disclose year-to-date totals for interest charges and fees. For many consumers, costs disclosed in dollars are more readily understood than costs disclosed as percentage rates. The year-to-date figures are intended to assist consumers in better understanding the overall cost of their credit account and are an important disclosure and an effective aid in understanding annualized costs. Staff believes these figures will better ensure consumers understand the cost of credit than the effective APR currently provided on periodic statements.

The effective APR. The draft final rule would eliminate the requirement to disclose the effective APR. Consumer testing conducted both prior to issuance of the June 2007 Proposal and subsequently, demonstrates that consumers find the disclosure of an effective APR that combines rates and fees to be confusing. The June 2007 Proposal required disclosure of the fees in a manner that is more readily understandable and comparable across institutions. Staff believes that this approach can better inform consumers and further the goals of consumer protection and the informed use of credit for all types of open-end credit.

Staff also considered whether there were competing considerations to support retention of the requirement to disclose an effective APR. First, staff considered the extent to which "sticker shock" from the effective APR benefits consumers, even if the rate disclosed may not enable consumers to meaningfully compare costs from month to month or between different credit products. A second consideration is whether the effective APR may be a hedge against fee-intensive pricing by creditors, and if so, the extent to which it promotes transparency. On balance, however, staff believes that the benefits of eliminating the requirement to disclose the effective APR outweigh these considerations.

The consumer testing conducted for the Board strongly supports this determination. The overall results of the testing show that the overwhelming majority of consumers do not correctly understand the effective APR. Some consumers in the testing offered no explanation of the difference between the corresponding and effective APR, and others appeared to have an incorrect understanding. Quantitative testing confirmed that very few consumers understand the effective APR, and that its disclosure on the periodic statement confuses some consumers when they try to find the interest rate applicable to the account.

Even if some consumers have some understanding of the effective APR, staff believes sound reasons support eliminating the requirement for its disclosure. Disclosure of the effective APR on periodic statements does not assist consumers in credit shopping, because the effective APR disclosed on a statement on one credit card account cannot be compared to the nominal APR disclosed on a solicitation or application for another credit card account. In addition, even within the same account, the effective APR for a given cycle is unlikely to accurately indicate the cost of credit in a future cycle, because if any of several factors (such as timing of transactions and payments) is different in the future cycle, the effective APR will be different even if the amount of the transaction is the same. As to suggestions that the effective APR for a particular billing cycle provides the consumer a rough indication that the cost of transactions triggering transaction fees is high, staff believes the requirements adopted in the final rule to disclose interest and fee totals for the cycle and year-to-date will better serve the same purpose.

Transactions. Currently, there are no format requirements for disclosing different types of transactions, such as purchases, cash advances, and balance transfers on periodic statements. Often, transactions are presented together in chronological order. Consumer testing prior to the June 2007 Proposal indicated that participants found it helpful to have similar types of transactions grouped together on the statement. Consumers also found it somewhat helpful, within the broad grouping of fees and transactions, when transactions were segregated by type (e.g., listing all purchases together, separate from cash advances or balance transfers). For these reasons, the June 2007 Proposal would have required creditors to group similar transactions together by type, such as purchases, cash advances, and balance transfers.

Staff is not recommending adoption of the proposed requirement that creditors group transactions by type on the periodic statement. In consumer testing, most consumers indicated that they review the transactions on their periodic statements, and grouping transactions only moderately improved consumers' ability to locate particular transactions compared to when the transaction list was presented chronologically. Staff believes that this modest improvement in performance may not justify the cost to creditors of reformatting periodic statements to group transactions by type. Furthermore, providing flexibility in how transactions may be presented would allow creditors to disclose transactions grouped by authorized user or by other sub-accounts, which consumers may find useful. Accordingly, under the draft final rule, creditors may list transactions in any way that is clear and conspicuous to consumers, such as listing transactions chronologically, by transaction type, or by authorized user.

Minimum payments. The Bankruptcy Act requires creditors offering open-end plans to provide a warning about the effects of making only minimum payments. The Board proposed to implement this requirement solely for credit card accounts which was the primary area of Congressional concern. As proposed, under the draft final rule, card issuers must provide (1) a "warning" statement indicating that making only the minimum payment will increase the interest the consumer pays and the time it takes to repay the consumer's balance; (2) a hypothetical example of how long it would take to pay a specified balance in full if only minimum payments are made; and (3) a toll-free telephone number that consumers may call to obtain an estimate of the time it would take to repay their actual account balance using minimum payments. Most card issuers must establish and maintain their own toll-free telephone numbers to provide the repayment estimates. However, the Board is required to establish and maintain, for two years, a toll-free telephone number for depository institutions having assets of $250 million or less.[19] In order to standardize the information provided by card issuers to consumers through their toll-free telephone numbers, the Bankruptcy Act amendments direct the Board to prepare a generic "table" illustrating the approximate number of months it would take to repay an outstanding balance if the consumer pays only the required minimum monthly payments and if no other advances are made ("generic repayment estimate").

Pursuant to the Bankruptcy Act amendments, the draft final rule also allows card issuers to establish a toll-free telephone number to provide customers with the actual

[19] The FTC must maintain a similar toll-free telephone number for use by customers of creditors that are not depository institutions. In contrast to the Board's mandated toll-free telephone number, the FTC must operate its toll-free number indefinitely.

number of months that it will take consumers to repay their outstanding balance ("actual repayment disclosure") instead of providing an estimate based on the Board-created table. A card issuer that does so need not include a hypothetical example on its periodic statements, but must disclose the warning statement and the toll-free telephone number.

The draft final rule also allows card issuers to provide the actual repayment disclosure on their periodic statements instead of establishing a toll-free number. Participants in consumer testing who typically carry credit card balances (revolvers) found an estimated repayment period based on terms that apply to their own account more useful than a hypothetical example. To encourage card issuers to provide the actual repayment disclosure on their periodic statements, the final rule provides that if card issuers do so, they need not disclose the warning, the hypothetical example and a toll-free telephone number on the periodic statement, nor need they maintain a toll-free telephone number to provide the actual repayment disclosure.

4. Changes in Consumer's Interest Rate and Other Account Terms

Regulation Z requires creditors to provide advance written notice of some changes to the terms of an open-end plan. The proposal included several revisions to Regulation Z's requirements for notifying consumers about such changes.

Currently, Regulation Z requires creditors to send, in most cases, notices 15 days before the effective date of certain changes in the account terms. However, creditors need not inform consumers in advance if the rate applicable to their account increases due to default or delinquency. Thus, consumers may not realize until they receive their monthly statement for a billing cycle that their late payment the previous month triggered application of the higher penalty rate, effective the first day of the current month's statement.

Proposal. The proposal generally would have increased the amount of advance notice before a changed term can be imposed from 15 to 45 days, and required creditors to provide 45 days' prior notice even when the creditor increases a rate due to the consumer's delinquency or default or as a penalty. When a change-in-terms or penalty-rate notice accompanies a periodic statement, the proposal required a tabular disclosure on the front of the first page of the periodic statement showing the key terms being changed.

Recommendations.

Timing. Consistent with the proposal, the draft final rule requires that notice of a changed term be sent at least 45 days before the effective date of the change. The 45-day advance notice requirement will give consumers approximately one month after receiving a change-in-terms notice to seek alternative financing or otherwise to mitigate the impact of an unexpected change in terms.

Penalty rates. Currently, creditors must inform consumers that their rates are being increased due to default or delinquency, but not in advance of implementing the increase. Contractual thresholds for default are sometimes very low, and penalty pricing commonly applies to all existing balances, including low-rate promotional balances. The June 2007 Proposal also applied the proposed 45-day advance notice requirement to rate increases due to the consumer's delinquency or default or as a penalty to allow consumers to consider alternatives before the increase is imposed.

In the May 2008 Regulation AA Proposal, the Board proposed to prohibit banks from increasing the interest rate applicable to an outstanding balance on a consumer credit card account, with limited exceptions. Because the rate increase prohibition would not apply to new transactions, the Board noted that the proposed 45-day advance notice requirement under Regulation Z would generally enable consumers to review their options and decide whether to continue using the card for new transactions.

Industry commenters opposed this requirement, stating that the 45-day delay would not allow issuers to sufficiently manage risk. Industry commenters stated that other proposed disclosures in the application and solicitation table and at account opening would be sufficient to alert consumers about the circumstances under which a penalty rate could be triggered, and that advance notice was not needed when the triggering event actually occurs.

The draft final rule generally requires creditors to provide 45 days' advance notice before rate increases due to the consumer's delinquency or default or as a penalty, as proposed. Although the draft final rule enhances the disclosure of the circumstances under which the penalty rate may apply in the solicitation and application table as well as at account opening, staff believes that consumers will be more likely to notice and be motivated to act if they receive a specific notice alerting them of an imminent rate increase, rather than a general disclosure stating the circumstances when a rate might potentially increase. For many consumers, the 45-day notice will be the best opportunity for understanding that penalty pricing will apply to new balances and that, if the consumer is late by more than 30 days, the penalty rate may be applied to all existing balances as well.

Format. Currently, there are few format requirements for change-in-terms disclosures. As with account-opening disclosures, creditors commonly intersperse change-in-terms notices with other amendments to the account agreement, and both are provided in pamphlets in small print and dense prose. Consumer testing indicates many consumers set aside and do not read densely-worded pamphlets.

Under the draft final rule, creditors may continue to notify consumers about changes to the terms required to be disclosed by Regulation Z, together with other changes to the account agreement. However, if a changed term is one that must be provided in the account-opening summary table, creditors must provide that change in a summary table to enhance the effectiveness of the change-in-terms notice.

Creditors commonly enclose notices about changes to terms or rates with periodic statements. Under the draft final rule, if a notice enclosed with a periodic statement discusses a change to a term that must be disclosed in the account-opening summary table, or announces that a penalty rate will be imposed on the account, a table summarizing the impending change must be included. However, the table can appear on the front side of any page of the periodic statement, and would not be required to appear on the front of the first page of the statement as originally proposed.

5. Additional Protections

Advertising of "fixed" rates. Creditors sometimes advertise the APR for open-end accounts as a "fixed" rate even though the creditor reserves the right to change the rate at any time for any reason. Consumer testing indicated that many consumers believe that a "fixed" rate will not change, and do not understand that creditors may use the term "fixed" as a shorthand reference for rates that do not vary based on changes in an index or formula.

Proposal. The proposal would prohibit creditors from advertising a rate as "fixed," unless the advertisement specifies a time period the rate will be fixed and the rate will not increase during that period. If a time period is not specified, the advertisement may refer to a rate as "fixed" only if the rate will not increase while the plan is open.

Recommendation. The draft final rule adopts this provision as proposed.

"Open-end" plans comprised of closed-end features.

Background. Some creditors give open-end credit disclosures on credit plans that include closed-end features, that is, separate loans with fixed repayment periods. These creditors treat these loans as advances on a revolving credit line for purposes of Regulation Z even though the consumer's credit information is separately evaluated, the consumer may have to complete a separate application for each "advance," and the consumer's payments on the "advance" do not replenish the line. Provisions in the existing commentary to Regulation Z lend support to this approach.

Proposal. The proposal would have revised these commentary provisions to indicate closed-end disclosures rather than open-end disclosures are appropriate when advances are individually approved and underwritten, or if payments made on a particular sub-account do not replenish the credit line available for that sub-account. In response, many credit union commenters stated that the proposed revisions would result in a loss of convenience to consumers who would have to sign additional paperwork prior to the transaction in order to obtain closed-end loans. These commenters also stated that open-end credit disclosures are adequate and provide their members with the information they need on a timely basis, and that these members receive frequent reminders, via periodic statements, of key financial terms such as the APR.

Recommendation. The draft final rule adopts the proposed revisions clarifying that credit is not properly characterized as open-end credit if the creditor performs separate underwriting of individual advances. The draft final rule also clarifies that credit cards for which the line as a whole replenishes are open-end credit and creditors may offer credit cards having no preset credit limits while continuing to consider consumer requests for additional credit. However, staff recommends that the Board withdraw the proposed requirement that payments replenish the credit line on each sub-account as long as there is replenishment of the line as a whole. Commenters noted that requiring replenishment of the subaccount rather than replenishment of the line as a whole could adversely impact creditors' ability to offer promotional rates on a particular balance.

Cut-off times and due dates for mailing payments.

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. Some creditors use different cut-off times depending on the payment method. Consumer groups and others have raised concerns that the use of early cut-off times may effectively result in a due date that is one day earlier than the due date disclosed. In addition, in response to the June 2007 Proposal, consumer commenters urged the Board to address creditors' practice of using due dates on days that the creditor does not accept payments, such as weekends or holidays.

Proposal. The May 2008 Regulation Z Proposal provided that it would be unreasonable for a creditor to require that mailed payments be received earlier than 5:00 p.m. on the due date in order to be considered timely. In addition, the proposal provided that if a creditor does not receive and accept mailed payments on the due date (e.g., a Sunday or holiday), a payment received on the next business day is timely.

Recommendation. The draft final rule adopts the proposal regarding weekend and holiday due dates. In addition, the draft final rule adopts a modified version of the 5 p.m. cut-off time proposal to provide that a 5 p.m. cut-off time is an example of a reasonable requirement for payments. The two provisions complement the Regulation AA requirement that creditors provide consumers a reasonable amount of time to make payments.

III. Regulation DD (Truth in Savings)

Background on overdraft services. Overdraft services are sometimes offered to account customers as an alternative to traditional ways of covering overdrafts (for example, overdraft lines of credit or linked accounts). Coverage is generally provided "automatically" to consumers who meet a depository institution's criteria (for example, the account has been open a certain number of days or deposits are made regularly). Most institutions state that payment of an overdraft is at their discretion. The service may extend to checks as well as other transaction types, such as ATM withdrawals, debit card transactions, recurring payments, and ACH debits. If an overdraft is paid, the consumer is charged a flat fee for each item. A daily fee also may apply for each day the account remains overdrawn.

Background on the Truth in Savings Act (TISA). 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.[20]

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

Under the act and regulation, disclosures about account terms and fees 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, yields, and other information to be provided on the statements. The act and regulation also contain rules for advertising deposit accounts.

Staff recommends the Board publish final amendments to Regulation DD to address disclosure requirements for overdraft services.

Discussion

1. Disclosure of Aggregate Overdraft Fee Information

Background. In May 2005, the Board adopted final rules under Regulation DD which, among other things, required institutions that promote the payment of overdrafts to disclose on 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 were required to be provided for the statement period and for the calendar year-to-date to better inform consumers about the costs of overdrawing their accounts. In limiting the aggregate fee disclosure requirement to institutions that promote the payment of overdrafts, 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 the issuance of the May 2005 final rule, questions have been raised by institutions about the types of activities that constitute promotion of an overdraft service, and how institutions may inform consumers about the ability to opt out of the service without triggering the rule. As a result, the rule may have had the unintended consequence of discouraging transparency by some depository institutions regarding their overdraft payment practices. In addition, available data indicates that similar percentages of accountholders (25-40 percent) have one or more overdrafts paid during a calendar year 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.

Recommendation. The draft final rule requires all institutions to provide aggregate dollar amount totals of fees for paying overdrafts and returned-item fees on consumers' periodic statements, as proposed. Staff believes that the broader rule is appropriate to promote transparency and to ensure that all consumers overdrawing their accounts receive information about ongoing overdraft costs. The fee disclosures should assist consumers in managing their accounts and determining whether other overdraft products would be more appropriate for their needs. As proposed, the draft final rule also requires institutions to present aggregate fee disclosures in a tabular format to improve the disclosures' noticeability and effectiveness.

2. Disclosure of Deposit Account Balances

Background. TISA § 263(e) prohibits misleading or inaccurate advertisements, announcements, or solicitations. In February 2005, the Board and other banking agencies issued guidance on overdraft services. The guidance recommended as a best practice that, when consumers make a balance inquiry, institutions disclose the actual balance without including any funds the institution may provide to cover an overdraft item, because including such funds may cause consumers to inadvertently overdraw their accounts.[21]

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

Recommendation. The draft final rule provides that if an institution discloses balance information through an automated system, it must disclose a balance that excludes any funds that may be provided to cover an overdraft item, including funds provided through the institution's discretionary overdraft service or overdraft line of credit, or funds that may be transferred from another account of the consumer. Institutions also would be permitted, at their option, to provide additional balances that include funds available for paying overdrafts if the institution prominently states that these additional balances include such additional funds.

IV. Regulation E (Electronic Fund Transfers)

Background on the Electronic Fund Transfer Act (EFTA). The EFTA establishes rights, liabilities and responsibilities for consumers who engage in electronic fund transfer (EFT) services and for the financial institutions offering these services. Regulation E implements the EFTA, and a staff commentary provides guidance to facilitate compliance.

The act and regulation provide for certain basic consumer rights related to EFTs, including initial disclosure of the terms and conditions of an EFT service, documentation of EFTs by means of terminal receipts and periodic statements (typically, provided monthly) of account transactions, limitations on consumer liability for unauthorized transfers, error resolution procedures, and certain rights regarding preauthorized EFTs.

The act also authorizes the Board to prescribe regulations necessary to carry out the purposes of the title. The express purpose of the EFTA is to establish "the rights, liabilities, and responsibilities of participants in electronic fund transfer systems" and to provide "individual consumer rights."[22]

[22] 15 U.S.C. 1693(b).

Staff recommends publishing for comment proposed changes to Regulation E to provide consumers certain rights regarding overdraft services.

Discussion

1. Consumer Choice Regarding Overdraft Services

Background. In the May 2008 Regulation AA Proposal, the Board proposed to prohibit institutions from assessing any fees on a consumer's account in connection with an overdraft service, unless the consumer is given notice and the right to opt out of the institution's overdraft service, and the consumer does not opt out. The proposed opt-out right would have applied to overdrafts resulting from all methods of payment, including checks, ACH transactions (whether one-time or recurring), ATM withdrawals, and POS debit card transactions. In addition, the proposal would have required institutions to provide consumers a partial opt-out applying only to ATM and POS debit card overdrafts. While the Regulation AA proposal on overdraft services would have established the substantive opt-out right, the May 2008 Regulation DD Proposal set forth proposed requirements regarding the form, content, and timing requirements for the opt-out notice.

Comments on Proposal. The Board received approximately 1,500 comment letters on the overdraft services portion of the May 2008 Regulation AA Proposal. The Board also received over 600 comments in response to the Regulation DD Proposal regarding the form, content and timing of the opt-out notice.

Industry commenters generally argued that the cost of complying with the rule would exceed any consumer benefits. Industry commenters noted that a financial institution would assess the same fee whether a check is paid or returned, but that the payment of a check overdraft enables consumers to avoid other consequences, such as merchant fees for returned items and the furnishing of negative information for credit reports. Industry commenters further stated that the proposed model form regarding the opt-out right under Regulation DD did not sufficiently explain the consequences of opting out or that the payment of overdrafts is discretionary.

Industry commenters also raised a number of operational concerns concerning implementation of the proposed partial opt-out for ATM and POS debit card transactions. Most industry commenters stated that their systems are not currently able to implement a partial opt-out and that the reprogramming costs would be significant. Specifically, several industry commenters stated that most systems today can either pay overdrafts for all transaction types or pay overdrafts for none; however, these systems are not set up to pay overdrafts for certain transaction types (e.g., checks and ACH), but not others (e.g., ATM and POS debit card transactions). Some industry commenters, however, argued that if the Agencies deemed it necessary to create a consumer opt-out right, it should be limited to ATM withdrawals and POS debit card transactions because the majority of complaints about overdraft services arise in connection with debit card transactions in which the amount of the overdraft fee is substantially higher than the amount of the overdraft. Finally, some industry commenters recommended that the Board should instead address concerns about overdraft services under other regulatory authority, such as Regulation E.

Consumer groups, members of Congress, the FDIC, individual consumers, and others supported the Agencies' proposal. However, many of these commenters advocated that the rule should instead require institutions to obtain a consumer's affirmative consent (that is, opt-in) before any fees could be assessed for paying an overdraft. These commenters also argued that overdraft services provide extensions of credit that should be subject to TILA so that consumers would receive an effective annual percentage rate that they could use to compare the cost of overdraft services to the cost of other credit products.

Consumer testing. In the fall of 2008, the Board worked with a testing consultant, Macro International, Inc. (Macro), to revise the proposed model opt-out notice and conduct consumer testing of the revised notice. Two rounds of one-on-one interviews were conducted. During the first round, Macro tested an opt-out form that allowed consumers to opt out of the payment of overdrafts for all transaction types, including checks and recurring debits. In the second round, Macro tested an opt-out form that limited the opt-out to ATM withdrawals and one-time debit card transactions made at POS and online.

After reviewing the model disclosures, test participants generally understood the concept of overdraft coverage, and that they would be charged fees if their institution paid their overdrafts. Participants in the first round also appeared to understand that if they opted out of overdraft coverage, this meant their checks would not be paid and they could be charged fees by both their bank and by the merchant. During both rounds, virtually all of the participants indicated that they would not opt out if their checks would be returned unpaid. However, when asked if they would opt out if the choice was limited to opting out of overdrafts in connection with ATM withdrawals and debit card purchases, half of the participants indicated that they would consider doing so.[23]

Recommendation.

Staff believes that concerns about overdraft services are more appropriately addressed by using the Board's rulemaking authority under the EFTA. First, staff believes that it is unnecessary to cover check transactions. While there are some tangible benefits

[23] See Review and Testing of Overdraft Notices, Macro International, December 8, 2008.

to consumers from the payment of overdrafts for check transactions, these benefits are not evident with regard to the routine payment of overdrafts for ATM withdrawals and one-time debit card transactions. For instance, while financial institutions typically charge the same fee whether or not a check that would overdraw an account is paid, the payment of a check overdraft enables consumers to avoid other adverse consequences, such as merchant returned item fees. These consequences are not a concern with ATM withdrawals and one-time debit card transactions because the transaction is not completed if the payment is not authorized, so the harm from unanticipated overdraft fees is not counterbalanced by avoidance of a merchant fee.

Second, staff has considered the cost impact to consumers from overdraft fees assessed in connection with ATM and debit card overdrafts. For one-time debit card transactions in particular, the amount of the fee assessed may substantially exceed the amount overdrawn.[24] Third, staff notes that proposing to address overdrafts under the EFTA and Regulation E would ensure that any final rule applies to all depository institutions, including state-chartered credit unions which would not have been covered by the rules issued under the FTC Act.

Opt-out. The draft proposal sets forth two alternative approaches to providing consumers a choice regarding whether they want overdrafts paid for ATM withdrawals and one-time debit card transactions. The first approach would allow an institution to assess a

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[24] According to the FDIC's Study of Bank Overdraft Programs, the median dollar amount for debit card transactions resulting in an overdraft is $20. The FDIC's study also reported that POS debit overdraft transactions accounted for the largest share of all insufficient funds transactions (41.0%). See FDIC Study of Bank Overdraft Programs, at 78-79 (November 2008) (hereinafter, FDIC Study). This compares to the average cost of overdraft and insufficient funds fees of over $26 per item in 2007, as reported by the GAO. See Bank Fees: Federal Banking Regulators Could Better Ensure That Consumers Have Required Disclosure Documents Prior to Opening Checking or Savings Accounts, GAO Report 08-281, at 14 (January 2008). See also FDIC Study at 15, 18 (reporting a median per item overdraft fee of $27 for banks surveyed).

fee for covering ATM withdrawals and one-time debit card transactions that overdraw the consumer's account, unless the consumer opts out of the institution's overdraft service after receiving notice and an opportunity to opt out. The opt-out would not apply to overdrafts caused by other types of transactions, including checks, ACH transactions, and preauthorized transfers.

Opt-in. Staff is also recommending that the Board propose an alternative approach that would require the institution to provide notice and obtain the consumer's affirmative consent, or opt-in, before the institution could assess a fee or charge for paying any ATM and one-time debit card overdrafts. An opt-in rule would enable some consumers to avoid fees for an overdraft service they either did not request or were unaware they had.

Notice requirements. Under both approaches, institutions would be required to provide notice informing the consumer of the opt-out (or opt-in) right before the institution may assess any fee or charge for paying an ATM or one-time debit card overdraft. The proposed opt-out approach would also require disclosure of the opt-out right following the institution's assessment of any fees or charges for the payment of such overdrafts. The subsequent notice is intended to ensure that consumers – who may not focus on the information provided 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.

To facilitate compliance, the proposal provides model forms that institutions may use to satisfy their disclosure obligations under both approaches. Staff intends to conduct additional consumer testing of the proposed model forms following issuance of the new proposal.

Implementation of opt-out (and opt-in). The draft proposal would seek comment on different methods for implementing the consumer's opt-out (or opt-in) choice. For example, an institution may wish to implement a consumer's opt-out by providing an account that does not permit the payment of overdrafts for ATM withdrawals and one-time debit card transactions. The draft proposal also seeks comment on whether, and to what extent, an institution should be permitted to vary the terms, features, or conditions of the "opt-out" account.

Exceptions permitting assessment of fee. If the consumer opts out (or does not opt in), an institution could continue to pay overdrafts, but would not be able to assess a fee. The proposed rule provides limited exceptions allowing institutions to assess overdraft fees despite a consumer's election to opt out (or not to opt in), including where the institution authorized a transaction on the reasonable belief that there were sufficient funds available in the consumer's account at the time the institution authorized the transaction.

2. Overdraft Fees Charged in Connection with Debit Holds

Background. When a consumer uses a debit card to make a purchase, a hold may be placed on funds in the consumer's account to ensure that the consumer has sufficient funds in the account when the transaction is presented for settlement. This is commonly referred to as a "debit hold." During the time the debit hold remains in place, which may be up to three days after authorization, those funds may be unavailable for the consumer's use for other transactions.

In some cases, the actual purchase amount is not known at the time the transaction is authorized, such as when a consumer uses a debit card to pay for gas at the pump or pay for a meal at a restaurant. Consequently, a debit hold may be placed for an estimated amount which may exceed the actual transaction amount. The consumer may engage in subsequent transactions reasonably assuming that the account has only been debited for the actual transaction amount. Because of the excess hold, however, the consumer may incur overdraft fees for those subsequent transactions.

Proposal. In the May 2008 Regulation AA proposal, the Board proposed to prohibit institutions from assessing an overdraft fee where the overdraft would not have occurred but for a hold placed on funds in the consumer's account that exceeds the actual transaction amount. This proposal was intended to enable consumers to avoid the assessment of fees when the consumer would not have overdrawn the account had the actual transaction amount been presented for payment in a timely manner.

Consumer groups supported the proposed prohibition. Industry commenters opposed the debit hold proposal, stating that it would present significant operational difficulties. Several industry commenters expressed concern that the rule would require institutions to monitor accounts retroactively and manually adjust transactions and fees that have posted to the account. Otherwise, institutions would have to stop placing holds altogether which, industry commenters argued, raised potential safety and soundness concerns. Rather than adopting a substantive rule under Regulation AA, industry commenters urged the Board to use other existing regulatory authority, such as Regulation E, and require merchants to disclose at the point-of-sale when holds may be placed on debit card transactions.

Recommendation.

Staff recommends that the Board propose to address concerns about debit holds under Regulation E pursuant to the Board's authority under the EFTA.

General rule. The proposed rule would prohibit financial institutions from assessing a fee or charge for paying an overdraft if the overdraft would not have occurred but for a hold placed on funds in connection with a debit card transaction that exceeds the actual transaction amount. Thus, the proposal is intended to prevent institutions from assessing overdraft fees in circumstances where the consumer did not actually overdraw the account.

The proposed rule would only apply to debit card transactions in which the actual transaction amount generally can be determined by the merchant or other payee within a short period of time after the institution has authorizes the transaction. For example, the rule would apply to pay-at-the-pump fuel purchases where the actual transaction amount can be calculated once the consumer has finished pumping fuel. Similarly, when a consumer uses a debit card to pay a restaurant bill, the actual transaction amount can be determined once the consumer has signed the receipt and added a service tip. According to data submitted by one card network, restaurant and fuel purchases comprise over 95 percent of all transactions in which the settlement amount may not match the authorization amount.

The proposed rule would not apply, however, to debit holds in other retail environments where the actual transaction amount generally cannot be determined for a considerable period of time after the merchant has submitted a transaction for authorization. For example, when a consumer provides a debit card at check-in for a multi-night hotel stay, the transaction will not be submitted for settlement until the end of the consumer's stay. In this case, a hold may be placed on funds in the consumer's account at check-in, but will not be released until the consumer completes the stay (or when the hold must be released under card network rules, whichever comes first). Staff believes it would be impracticable to craft a rule to cover such transactions because it would be impossible to determine a reasonable hold period in all circumstances.

Nonetheless, staff believes the proposed rule would cover the transactions which are the greatest areas of concern regarding overdraft fees incurred because of a debit hold. As noted above, card network data indicates that hotel and car rental transactions comprise a very small proportion of transactions overall that involve a debit hold.

Safe harbor. To address industry concerns about potential operational burdens, the proposal would allow institutions to assess an overdraft fee in connection with an excess hold if they have adopted procedures designed to release the hold in a reasonable period of time. The proposal sets forth a safe harbor for institutions that adopt procedures and practices to remove the hold within two hours of authorization. The proposed safe harbor is consistent with industry efforts to minimize hold times in pay-at-the-pump fuel transactions, suggesting that such a standard is feasible.

CONCLUSION

Staff recommends that the Board publish (1) final amendments to Regulation AA prohibiting certain unfair practices in connection with credit cards; (2) final amendments to Regulation Z to revise the disclosure requirements for credit card accounts and other open-end (revolving) plans that are not home-secured, and to provide additional consumer protections for credit card accounts; and (3) final amendments to Regulation DD to address disclosure practices regarding overdraft services and fees. The staff also recommends that the Board publish for comment proposed amendments to Regulation E to prohibit certain practices in connection with the assessment of overdraft fees. Staff requests authority to make minor and technical changes as necessary to the Regulation AA rules 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.