March 18, 2005

Commentary – Federal Reserve System
12 CFR Part 226 – Regulation Z; Docket No. R-1217
Truth in Lending – Advanced Notice of Proposed Rulemaking

I really had no intention of responding to this ANPR until I noticed a solicitation that my wife had received from Fleet-Bank of America with "convenience" checks offering a variable APR of 5.25% until the unpaid balance of the advances created by these checks is paid in full. At first glance it appeared that the 5.25% rate was fixed until the money was repaid, but further disclosure proved that the rate would change when the "prime rate" changes. (Note: the "prime rate" index was not defined in the offer. I presume that it will be Fleet prime rate until it is raised to Bank of America prime rate.) Then in small print it further discloses that a 3% transaction fee will be charged against the amounts advanced with the "convenience checks". I had to wonder: if the **APR** is 5.25% then does the finance charge include the rate charged plus the transaction fee or do they really mean the interest rate is 5.25% variable PLUS the 3% transaction fee? Consider: Paragraph 226.14 defines **Annual Percentage Rate (APR)** as a measure of the cost of credit expressed as a yearly rate. It further instructs that the disclosed **Annual Percentage Rate (APR)** is computed by multiplying the **Periodic Rate** by the number of periods in a year. Paragraph 226.2 defines **Periodic Rate** as a rate of **Finance Charge** that is or may be imposed by a creditor on a balance for a day, week, month or other subdivision of a year. Paragraph 226.4 defines **Finance Charge** as the cost of consumer credit expressed as a dollar amount. **Finance Charge** includes any charge payable directly or indirectly by the consumer and imposed directly or indirectly by the creditor as an incident to or a condition of the extension of credit. (This includes interest, balance transfer fees, cash advance fees and transaction fees). By these measures I have concluded that if one check was written for $1,000.00 that the "actual" **APR** is **41.744%.** (30 day interest charge of $4.31 plus the required transaction fee of $30.00 for a total monthly **period Finance Charge** of $34.31.)

Actually, I have been aware for a good number of years that credit card solicitors have been running amok with impunity because of lax interpretation and regulation of the FRB Regulation Z TILA. Cases in point are recent Capital One, Chase Manhattan Bank and HSBC solicitations for new credit card accounts. Capital One offers one **fixed APR** for purchases, Chase offers two **fixed APR's** for purchases and HSBC offers three **fixed APR's.** I have always thought that "fixed rate" meant not changeable, but, even though "purchase" APR's are omitted from the "variable-rate information" disclosure boxes, in footnotes, they disclose that **fixed rate** really means either **variable rate** or any **higher rate** they choose to charge for any reason**.** I would think that if each card account has one interest rate for purchases plus one interest rate for cash advances plus cash advance transaction fees plus balance transfer transaction fees that the sum of all interest rates plus all transaction fees would equal one **Finance Charge** and therefore, one **APR.** Further, all of the solicitations that I reviewed disclose a very high **Default Rate** and, in footnotes, define an event of Default as just about anything that suits their fancy at any time other than the possible exception of using the card. These solicitations also seem to be very liberal in describing the term "**APR**". I found **<u>interest rates</u>** described as Prime + APR, Standard APR, Fixed APR, Variable APR, Balance Transfer APR, Cash Advance APR, Introductory APR, and Default APR. Even the authors of the ANPR use terms like "effective" APR, "historical" APR and "nominal" APR. There can be fixed interest rates, variable interest rates and multiple interest rates. There can be prime interest rates and prima dona interest rates but there is only one **APR** and it is the **<u>Total Finance Charge</u>** <u>expressed as a percentage of the **Total Amount Financed**</u>**.**

The Industrial Revolution of the late 1800's is generally acknowledged as the impetus for converting America from a "free-spirited" wilderness society to a communal urban society that became reliant on friends, relatives and neighbors for survival. Urban life during this period resulted in an occasional need to borrow money in order to maintain the basic necessities of life. But society deemed borrowing money as shameful. This social attitude was responsible for creating borrowing solutions that were ripe for manipulation and resulted in the advent of "back alley" lenders, loan sharks and indentured servitude. The business enterprises created to offset these bad guys included the origin of pawnshops, lending societies, credit unions and finance companies. All of these entities were well intentioned at first but by early 1900's had increased interest rates as high as the market would bear. Never the less, growing consumer demand for credit resulted in the introduction of the first model Uniform Small Loan Law in 1916 by the Russell Sage Foundation. Their research established regulatory guidelines for all classes of consumer lenders. Their studies validated the need and legitimacy of consumer credit and supported lenders need for fair pricing of their loan products. At the urging of the foundation members, Uniform Small Loan Laws were adopted in various modified formats by almost every state in the union. These laws set the framework for protecting consumers, closing down unethical lenders and set the stage for regulatory oversight of the revised consumer credit practices including maximum interest rates.

The USLL also created an expansion of the consumer credit industry. It was now socially acceptable to borrow money and to purchase consumer goods with installment credit. Finance companies expanded, automobile manufacturers set up financing outlets, and retailers opened charge accounts. Mass media advertisements encouraged the use of credit for any and all purposes. The national economy now became dependent on consumer credit to sustain growth and productivity. Life was good.

The USLL provided confidence in the consumer credit markets and few advances in consumer credit technology were achieved over the next 50 years of this era. But ultimately, competition and social pressures combined to support reductions in loan pricing. During this time new terminology was devised to describe the methodologies for disguising high interest rates on installment credit. Interest rates were now being disclosed as discount rates, add-on rates and Rule of 78's calculations. Examples: disclosing an "8% discount rate" as 8.00% really resulted in an annual percentage rate of approximately 19.20% ($100.00 discounted by $8.00 payable over 50 weeks at $2.00 per week); and, disclosing an "8% add-on rate" as 8.00% equaled an annual percentage rate of approximately 15.9% ($100.00 plus $8.00 add-on interest payable over 12 months at $9.00 per month). The ultimate confusion of consumer credit costs led to congress enacting the Truth In Lending Act to provide uniform disclosure of the cost of a credit transaction as compared to a similar cash transaction.

As a consumer credit lender prior to TILA and now as a Bank Senior Lending Officer, I can attest to the fact that legitimate lenders were not and are not now gouging consumers for excessive profits. Consumer lending is a basic necessity of American life BUT Consumer lending is RISKY. Consumer lending is EXPENSIVE. To demonstrate this sad fact, I reviewed income data from financial reports (bank call reports) of five randomly selected credit card banks. I found that their combined interest and fee income in 2004 was $12,154,145,000.00 and THE AMOUNT OF THEIR COMBINED CHARGE OFF TO BAD DEBT WAS $4,317,715,000.00 or **36% OF INCOME.** (Cost of funds and total expenses for credit card operations is not available.)

For many years after the enactment of TILA, society pressured the consumer lending industry to make credit widely available to the public without discrimination of any kind. The credit card industry is to be commended for achieving that goal. Anyone, regardless of his or her credit standing can obtain a credit card. It may be secured, it may have a higher finance charge but a revolving line of credit is legitimately available to every American consumer. This is why it is essential for the consumer to have proper disclosure of the true cost of open-end credit! The public will accept high rates if they are aware of the costs up front and if they are fair and reasonable to all. The Uniform Small Loan Laws and the Truth in Lending Act were created for the purpose of proper disclosure of the costs of consumer credit transactions because of abusive practices. If the "industry representatives" have the ingenuity for creating a multitude of income venues for this business enterprise, they are certainly equally capable of creating a <u>uniform</u> means of accurately and comparably disclosing the true total cost of open-end credit usage to the American Consumer. If not then it is time to design a new Really Truthful Uniform Cost of Open-End Credit Act!

Q1. Scope of the Review

Background – Actually the original purpose of the Truth in Lending Act was to provide meaningful and comparable credit information to consumers seeking credit. It was intended to encourage credit shopping and to increase consumer understanding about the actual cost of credit. Basically, TILA was designed to provide consumers with the information necessary to compare the costs of cash versus a credit transaction and to compare the difference in the cost of credit as among different creditors to avoid the uninformed use of credit and to protect the consumer against inaccurate and unfair credit billing and credit card practices.

This regulation as it was written adequately fulfills the purposes for which it was enacted. There are a few minor glitches (detailed later) that justify reviewing the act in stages and then completing a final evaluation of all the parts as a whole to assure cohesiveness of the TILA rules. I do not believe it is the regulation that needs to be improved; it is the interpretation (or rather the misinterpretation). As we found with the USLL, if we don't like the rules we call them complex and misinterpret them. The regulation does achieve its intended purposes when the information is properly disclosed. In discussing the <u>Open-end Consumer Credit in Today's Marketplace</u>, the "increased number of cards held" and the "wide range of uses" are the **results** of an effective regulation not a cause to change it. Likewise, the "more complex pricing" statement is a fallacy. A single account **CANNOT** have multiple APRs for different types of credit extensions. A single account may have multiple Interest Rates and multiple categories of fees that all add up to ONE **FINANCE CHARGE** and therefore ONE **APR.** Finally, the last two bullets, "additional account features" and "consumers perceptions about account information" also fully demonstrate the achievement of the purpose of the Truth in Lending Act as it was written…….

Q2. I am really having a problem with the ANPR author(s)'s misuse of terminology like "APR" for Interest Rate, "account-opening disclosure" for Initial Disclosure Statement and "Schumer box disclosure" for Fed Box (Federal Reserve Disclosure Box). The first formatting rule that needs to be in place is to require consistent terminology based on the definitions and terms stated in Reg. Z. Next we need to outline the sequences of disclosure events. First we have (226.5a) Credit and Charge Card Applications and Solicitations (the advertisement), then (226.6), Initial Disclosure Statement (the offer) and finally (226.7), the Periodic Statement.

A. Advertisement – Because of the vast disparity in credit risk levels for general market solicitations, it is not practical or realistic to increase requirements on the generic disclosures for "take-one" applications and blanket mail-out promotions. However, "pre-approved' and "pre-screened" offers should be more definitive and precise with the information provided in the Fed box. These offers should be almost identical to the Initial Disclosure Statement but should be subject to the "Terms of Pre-Approved Offer" in the Disclosure statement.
B. Offer – Upon approval by the credit card issuer, the Initial Disclosure Statement must detail the full disclosure of interest rates, terms and conditions.
C. The "Summary of Terms" (Fed box) should be corrected as follows for both pre-approved offers and the initial disclosure statement:

Balance Categories	Interest Rates and Fees Charged
Purchases	0.00% until (expiration date), after that, WSJ Prime** Rate plus 2.00%, currently 6.50%
Cash Advances/Cash Advance Checks	WSJ Prime Rate plus 5.00%, currently 9.50% plus Cash Advance Fee of 3.00% of the amount advanced. ($10.00 minimum charge)
Balance Transfers/Balance Transfer Checks	0.00% until (expiration date), after that, WSJ Prime Rate plus 3.00%, currently 7.50% plus Balance Transfer fee of 3.00% of the amount advanced. ($10.00 minimum charge)
Default/Penalty Rate	WSJ Prime Rate plus 12.00%, currently 16.50%
Overdraft Advances	WSJ Prime Rate plus 15.00%, currently 19.50%
*Variable Interest Rate Information	Your interest rates are fixed for the term of the billing cycle and may vary for each new billing cycle. The rates are determined on the first day of the billing cycle by adding the index rate of Prime Rate, as stated daily in the Wall Street Journal, plus the Balance Category increase.

Annual Percentage Rate - APR	Your **APR** may vary. This rate is determined by adding the Total Interest Charges of each of the above categories to the Total Fees Charged in each of the above categories and disclosing this Total Finance Charge as a percentage of the average outstanding balance during the current billing cycle.
Current Billing Cycle APR	**41.710%*** **
Penalty Fees	Over-the-limit Fee - $35.00 **Late Charge - $39.00 if payment is not received within 20 days after the "payment due" date**.
Grace Period for repayment of Balance for Purchases	**20 days after the "payment due" date.**
Method of computing the Balance for Purchases	Average daily balance during the billing cycle
Annual Fees	None
Transaction fees for purchases	None
**WSJ Prime Rate is the rate of interest defined and disclosed daily in the Wall Street Journal as the Prime Rate.	

***Example: Current Billing Cycle APR Calculation is based on the following:

Billing Cycle Average Balance for Purchases =	$100.00
Billing Cycle Average Balance for Cash Advances =	<u>$100.00</u>
Total Average Outstanding Billing Cycle Balance =	$200.00
Billing Cycle Interest Charge for Purchases @6.50% =	$ .54
Billing Cycle Interest Charge for Cash Advances @ 9.50% =	$ .79
Billing Cycle Cash Advance Fee at 3.00% =	<u>$3.00</u>
Total Billing Period Finance Charge	$4.33

APR for the **Finance Charge** of $4.33 and Outstanding Average Balance of $200.00 equals an **Annual Percentage Rate of 26.92%**

Q4. I concur that the payment due date and the grace period expiration date should be located in a conspicuous location on the first page of the statement.

Q5. The cost of credit would definitely be more effectively presented on the periodic statements if all charges were grouped together but with Finance Charge fees and interest charges labeled and identified separately from the penalty/default/late fees.

Q7. No, the Fed Box needs to be redesigned to properly define the difference between APR and Interest Rates and Fees and Total Finance Charge.

Q8. <u>All</u> fees, rates, and charges that are assessed during the billing cycle should be disclosed clearly and conspicuously in the FED Box.

Q9. and Q10. and Q11. No changes are necessary

Q13. If we remember the original reason of the Truth in Lending Act is to provide consumers with the information necessary to compare the costs of a cash transaction to a similar credit transaction then it is imperative that the components of the Total Finance Charge include all fees imposed as a condition of the credit as well as fees imposed incidental to the credit. Other charges should be defined as <u>Reasonable</u> penalty fees (overdraft, late payment, overlimit, NSF check, etc.) for misuse of the credit privilege.

Q14. Consumers will be adequately educated on costs of credit if the industry representatives properly interpret the disclosure requirements of the TILA and provide meaningful and comparable open-end credit information on applications, solicitations, Initial Disclosure Statements and Periodic Statements.

Q15. Based on the current disclosure interpretations, the consumer would be hard pressed to understand that open-end credit charges and fees are components of the Finance Charge definition.

Q16. Q17. Q18. These questions seem to be a little redundant. 226.4 (a)(b)(c) adequately define what is and what is not a finance charge. Any excuse for additional fees is not a concern provided any periodic fee is added to the total finance charge and to the APR. Additional features to open-end credit accounts can be demonstrated to the consumer by comparing APRs with and without the feature(s).

Q20. It is essential that the rules used to classify fees for open-end accounts mirror the classification rules for closed-end accounts and real estate related fees to prevent any possible terminology confusion by the consumer.

Q21. Q22. What is the problem here? I cannot believe that current technology cannot prevent consumers from exceeding their limits. If the consumer somehow should exceed their credit limit (i.e. payment reversal) past the current period without creditor intervention, then I would presume that the creditor has by default authorized a credit limit increase! Obviously the Board needs to provide a means of consumer protection from the probability of abuse in compliance with this ANPR author's second stated purpose of the TILA, "(2) to protect consumers against inaccurate and unfair billing and credit card practices."

Q23. No, returning to a proper definition and disclosure of the Annual Percentage Rate properly informs consumers of the effects of market changes and/or usage habits and creditor imposed charges and fees.

Q24. Again, the way to improve consumer's understanding of the definition of the APR is to disclose it per TILA and make information about the components (interest, charges, fees, etc.) of the Total Finance Charge for the current billing cycle available in periodic statements.

Q25. Yes, it would be useful to consumers to have the disclosure of the Total Finance Charge in a total dollar amount separated from the total dollar amount of "other charges".

Q26. No, 15 days is inadequate notice of a change in the interest rates **if** they are described as Fixed. It now takes credit card issuers approximately 10 days to process a new card request and issue an Initial Disclosure Statement. At least 30 days notice should be the minimum considered with 45 days being the desired level to allow the consumer adequate time to shop for and consider an alternate source of credit.

Q29. The Average Daily Balance method was standard and understandable without further disclosure. The Two Cycle Average Daily Balance method that is gaining creditor popularity has a very complex definition and is ripe for misinterpretation by creditors and consumers. The Board should definitely consider eliminating this methodology from the regulation.

Q36. It would be very appropriate for the Board to consider amending Reg. Z to require payment allocation disclosure. The ANPR author seems to have the normal creditor practice backwards. My observations indicate that creditors tend to apply principal reductions to the "low-rate" balances (to assure additional interest charges on the high-rate balances) before paying down high-rate cash advance and/or balance transfer balances.

Q37. The board absolutely should NOT permit over or understatement of the finance charge on open-end or closed-end credit. The integrity of this Regulation must be maintained to assure continued consumer trust. The tolerance should remain the traditional .125 to preserve uniformity in the regulation.

Q42. No! Even the rich and famous need the same information available to misunderstand as us poor folks.

Q43. I have indicated throughout this commentary that I fully believe that Regulation Z TILA is totally adequate in its present form with only a few minor adjustments. If industry representatives are confused, the Board and/or their regulators should provide recommended interpretation and enforcement for them. The ultimate test is the understanding and acceptance of the disclosures by consumers.

Q54. The rules of this Regulation are clearly stated and effectively organized in its present format. Altering or revising its present content would make it unnecessarily complex and easier to misinterpret.

Q55. No!

I thank the Board of Governors for the opportunity to provide input into this important stage of regulation review. This is certainly a very tough nut to crack and the impact of your final decisions on the American consumer will be tremendous. In fact, because of the increasing levels of open-end credit, even our national economy can be affected by your final rulings. I am convinced that this regulation in its present form is fully adequate to satisfy the purposes for which it was intended. I also believe that open-end credit issuers should be provided better interpretation and enforcement of the terms and conditions of the regulation and thereby enabling a means for them to relay those interpretations to the American consumer in a manner that provides meaningful and comparable credit information to them.

Sincerely,

Thom Conus
106 E. Cleveland
P O Box 729
Monett MO 65708
417-235-6100
Fax: 417-235-4359
e-mail: thomc@mo-net.com

Note: Although I am an officer of a community bank, the opinions expressed herein are strictly my own. The Board of Directors of that bank have neither instigated, endorsed nor approved these statements and bear no responsibility whatsoever for the content of this commentary.