

Federal Reserve Limits Credit Card Penalty Fees

On June 15, 2010, the Federal Reserve issued its third and final set of rules (Final Rule) implementing the Credit Card Accountability Responsibility and Disclosure Act of 2009 (CARD Act), through amendments to Regulation Z. This Final Rule:

- places limits on penalty fees charged by credit card issuers;
- prohibits issuers from imposing penalty fees that exceed the dollar amount associated with the violation; and
- prohibits issuers from imposing multiple penalty fees based on a single event or transaction.

The Final Rule also requires that credit card issuers who have increased the annual percentage rate (APR) on an account disclose the principal reasons for that increase and reevaluate whether the reasons for the increase have changed at least once every six months. A summary of the Final Rule, which becomes effective on August 22, 2010, is set forth below.

I. LIMITATIONS ON PENALTY FEES

The Final Rule requires that penalty fees imposed by card issuers either:

- be “reasonable and proportional” to the violation of the account terms; or
- conform to certain safe harbor fee limits described below.

An issuer, however, is permitted to vary its fee structure by credit card portfolio and by type of violation. For example, an issuer may choose to use a “reasonable and proportional” fee determination for late payment fees, but the safe harbor fee structure for over-the-limit fees. See 12 C.F.R. § 226, Supplement I. Accordingly, it would be advisable for issuers to calculate the fees that are permissible under the “reasonable and proportional” standard and compare them to the fees permitted by the safe harbor fee limits to determine which fee structure would be most beneficial.

A. Fees Based on Costs

The CARD Act added a new section to the Truth in Lending Act (TILA), 15 U.S.C. § 1601 *et seq.*, mandating that the amount of any penalty fee or charge that a card issuer may impose with respect to a credit card account in connection with any omission with respect to, or violation of, the cardholder agreement, must be reasonable and proportional to the omission or violation. See CARD Act, Section 149(a). In the preamble to the Final Rule, the Federal Reserve stated that it believes the dollar amount of a penalty fee would be generally reasonable

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and proportional to a violation if it represents a “reasonable proportion of the total costs incurred by the issuer as a result of all violations of the same type.”

For purposes of this rule (and the safe harbor fee limits set forth below), penalty fees are defined to include: late payment fees, returned payment fees, over-the-limit fees, declined access check fees, fees for a transaction that the issuer declines to authorize, account inactivity fees, and account termination fees. However, excluded from the definition of penalty fees are the following: balance transfer fees, cash advance fees, foreign transaction fees, annual fees unless based on account inactivity, fees for insurance or debt cancellation or debt suspension coverage, fees for making expedited payment, fees for optional services, and fees for reissuing a lost or stolen card.

Thus, if an issuer chooses the “reasonable and proportional” option, the issuer would need to determine the total costs it incurs when a cardholder violates a card agreement. The issuer may make a single determination for all of its credit card portfolios or it may make separate determinations for each portfolio. The factors relevant to the issuer’s determination include:

- (1) the number of violations of a particular type during a reasonable time period (such as 12 months);
- (2) the costs incurred by the issuer as a result of those violations;
- (3) at the issuer’s option, the number of fees imposed as a result of those violations that the issuer reasonably estimates it will be unable to collect; and
- (4) at the issuer’s option, reasonable estimates for an upcoming period of changes in the number of violations, costs of violations, or estimates of fees the issuer will be unable to collect.

A cost analysis may not include the cost of holding reserves against potential losses, the cost of funding delinquent accounts, and the cost associated with evaluating whether consumers who have not violated the terms or other

requirements of an account are likely to do so in the future. Furthermore, if the issuer chooses the “reasonable and proportional” option, it would need to re-evaluate its costs every twelve months and adjust the fee accordingly. And, as noted below, these fees must be further limited so that they do not exceed the amount of the violation.

In the Official Staff Interpretations to Regulation Z, the Federal Reserve provides sample calculations of fees that would represent a reasonable proportion of the total costs incurred by the issuer, and thus comply with the Final Rule. See 12 C.F.R. § 226, Supplement I. For example, if during the past year the issuer experienced 1 million delinquencies and incurred US\$26 million in costs as a result of those delinquencies, then for the next year a US\$26 late payment fee would represent a reasonable proportion of the total costs incurred by the issuer as a result of late payments (i.e., US\$26 million divided by 1 million delinquencies equals a cost of US\$26 per delinquency). If the issuer was unable to collect 25 percent of the late fees charged during the first year, then it could charge a late payment fee of US\$35 during the next year in accordance with the “reasonable proportion of the total costs” standard (i.e., US\$26 million divided by 750,000—the net amount of late payments for which it collected or could have collected a fee—equals a cost of US\$35 per late payment). The issuer may adjust the calculated fee based upon reasonable estimates of future changes, such as estimates that its delinquency rates will decrease by 2 percent, that it will be unable to collect 25 percent of the late fees, and that it will experience a 5 percent increase in costs. Factoring in these reasonable estimates would justify a US\$37 late payment fee in this example.

B. Safe Harbor Fee Limits

Instead of assessing penalty fees based on costs, an issuer may assess penalties subject to certain safe harbors, which are in effect fee limits or ceilings on the total fees that can be charged. Specifically, under the safe harbors, an issuer may only impose up to a US\$25 penalty fee for a first violation and up to a US\$35 penalty fee for any additional violation of the same type during the next six billing cycles, except that an issuer of a charge card—that requires payment

of the outstanding balances in full at the end of each billing cycle—may impose a late payment fee that does not exceed 3 percent of the delinquent balance when the issuer has not received a required payment for two or more consecutive billing cycles. The US\$25 and US\$35 penalty amounts may be adjusted by the Federal Reserve annually to reflect changes in the Consumer Price Index.

C. Prohibition on Fees that Exceed the Dollar Amount Associated with the Violation

No fee imposed under either the “reasonable and proportional” cost method or the safe harbor rules may exceed the dollar amount associated with the violation. Thus, for example, if a consumer does not make a US\$20 minimum payment by the due date, the late payment fee may not exceed US\$20, even though the safe harbor would otherwise permit a US\$25 fee. As another example, if an issuer adopts the cost method and determines that a US\$27 fee represents a “reasonable proportion of the total costs” incurred by the card issuer as a result of a transaction that causes the customer to go over his or her credit limit, the issuer is prohibited from imposing a US\$27 fee if the transaction only caused the account to be US\$5 dollars over the customer’s credit limit. Rather, in this example, the issuer may not charge an over-the-limit fee of more than US\$5. If there is no dollar amount associated with a violation, such as for account inactivity or transactions that the issuer declines to authorize, then the issuer may not impose a penalty fee at all.

D. Prohibition on Multiple Fees Based on a Single Event or Transaction

As a further restriction on fees, the Final Rule prohibits a card issuer from imposing more than one fee for violating the terms or other requirements of a credit card account under an open-end consumer credit plan based on a single event or transaction. For example, the Final Rule prohibits issuers from charging a late payment fee and a returned payment fee based on a single late payment resulting from the cardholder’s attempt to make the payment with an insufficient funds check.

II. REEVALUATION OF ANNUAL PERCENTAGE RATE INCREASES

The Final Rule also would require issuers that have increased a consumer’s APR to reevaluate every six months whether the reasons for the rate increase have changed and, if appropriate, reduce the rate within 45 days after the evaluation is complete. This requirement would apply to all issuer rate increases that have occurred since January 1, 2009. In reevaluating the consumer’s rate, the issuer generally is not required to consider the same factors it used in determining the original rate increase, although there are exceptions. Specifically, the issuer may consider either the factors in which the original APR increase was based, or factors that the issuer currently considers when determining the APR rates applicable to similar new credit card accounts. However, for any rate increase that was imposed between January 1, 2009 and February 21, 2010, the issuer’s first two reviews for rate increases must only consider factors that the issuer currently uses in connection with new credit card accounts, unless the rate increase was based solely on factors that were specific to the consumer such as default, delinquency, or decline in the consumer’s creditworthiness.

The issuer’s obligation to review and reevaluate a consumer’s APR is not an ongoing one. Rather, if the issuer reduces the consumer’s APR to the same or lower rate that was applicable immediately before the original rate increase, then the issuer’s obligation to reassess the APR is terminated.

III. DISCLOSURES

A. Disclosure of Principal Reasons for an APR Increase

The CARD Act, as implemented through February 2010 amendments to Regulation Z, requires issuers to provide 45 days advance written notice to consumers when any of the following events occurs:

- a significant change in the terms disclosed at account opening;
- the acquisition of a security interest;

- an increase in the required minimum periodic payment; or
- an increase in the consumer's interest rate due to delinquency or default, or as a penalty.

The Final Rule implements an additional disclosure requirement for this advance written notice. For changes to a consumer's account that include an increase in the APR, creditors must provide a statement of no more than four principal reasons for the rate increase, listed in order of importance. This is a requirement imposed by Section 148 of TILA that is intended to help consumers identify whether their own actions can eventually help reduce the APR on their account. The creditor is not required to list a minimum number of reasons, and the reasons may be stated in general terms. For example, the notice of an APR increase triggered by a 100 point reduction in the consumer's credit score may simply state the increase is due to "a decline in your creditworthiness," or "a decline in your credit score." Also, if a rate increase is triggered by an increase in the card issuer's cost of funds, the issuer may list the reason for increase as "a change in market conditions." The Federal Reserve noted that it believed that a more specific disclosure of the principal reasons for an APR increase would be unnecessary, and potentially confusing to the consumer.

B. Highlighting of Maximum Fee Limits

Finally, the Final Rule requires issuers to use bold text when disclosing the maximum limits on fees in credit card application disclosures and account-opening disclosures. Additionally, if a range of late payment fees may be assessed, the card issuer must state the range of fees or the highest fee in the range with an indication that the fee imposed could be lower.

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The changes imposed by the Final Rules, in keeping with the requirements of the CARD Act, are designed to limit the fee and APR burdens on cardholders. However, they will almost certainly require yet another round of new disclosures and additional programming costs on issuers to implement. And the fee limits will almost certainly

further reduce issuer revenues than was contemplated by previous rulemakings. In this regard, the Federal Reserve noted in the preamble to the rules that late fees and over limit fees have been averaging about US\$39—well more than the fee limits set in the safe harbor provisions of the Final Rule.

Arnold & Porter LLP is available to respond to questions raised by the Final Rule. We can assist you in determining how the Final Rule and other new credit card regulations may affect your business and industry. For further information, please contact your Arnold & Porter attorney or:

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