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CLIENT ADVISORY

FEDERAL BANK REGULATORS ADOPT NEW RULES CURTAILING UNFAIR AND DECEPTIVE CREDIT CARD PRACTICES AND MODIFYING DISCLOSURE REQUIREMENTS

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On December 18, 2008, the Board of Governors of the Federal Reserve System (Board), the Office of Thrift Supervision (OTS), and the National Credit Union Administration (collectively, the Agencies), following consultation with the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Federal Trade Commission (FTC), issued final rules (Final Rules) prohibiting financial institutions from engaging in certain activities in connection with consumer credit card accounts and modifying disclosure requirements related to open-end credit plans and overdraft services.[1] The Agencies also proposed new rules regarding overdraft services for consumer deposit accounts.[2] Citing concerns over abusive credit practices and a lack of consumer understanding and choice, the Agencies in the Final Rules declared various credit card lending practices "unfair or deceptive" under section 5(a) of the Federal Trade Commission Act (FTC Act).

The Final Rules reflect the increased regulatory scrutiny of consumer credit terms—scrutiny that has only intensified in the wake of the subprime mortgage crisis. The Final Rules also illustrate the Agencies' willingness to take a more active and aggressive approach toward consumer protection—a trend that will only continue next year with a Democratic administration. Unlike previous rulemakings, which have focused on improving disclosure, the Final Rules go further by imposing substantive credit terms, including prohibiting certain lending activities outright, and by significantly limiting the fees that may be charged in connection with the extension of consumer credit. The Agencies noted that the Final Rules were prompted, in part, by the inability of many consumers to understand disclosures for certain types of financial products. Thus, the Final Rules, summarized below, impose significant new regulatory requirements upon financial institutions, which merit careful consideration and require swift action to ensure compliance.

SUMMARY OF REGULATION AA FINAL RULE

The Final Rules first amend Regulation AA to prohibit certain allegedly unfair or deceptive practices by banks in connection with credit card accounts.[3] Key provisions

1 The Final Rules amend 12 C.F.R. §§ 226, 227, and 230 (Regulations Z, AA, and DD, respectively).
2 The proposed rule would amend 12 C.F.R. § 205 (Regulation E).
3 The Final Rules are promulgated pursuant to section 18(f)(1) of the FTC Act, which makes the Agencies responsible for prescribing regulations that prevent unfair or deceptive acts or practices

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of these amendments, which are effective July 1, 2010, include the following:

1. ***Provisions Requiring a "Reasonable" Time for Consumers to Make Payments.*** The Final Rules prohibit financial institutions from treating a payment as late unless the consumer has been given a "reasonable" amount of time to make the payment. A safe harbor is provided for institutions that adopt "reasonable" procedures to ensure that consumer statements are mailed or delivered at least 21 days in advance of the payment due date.
2. ***Provisions Requiring Specific Payment Allocation Methods.*** When different annual percentage rates (APRs) apply to different customer balances, the Final Rules require financial institutions to apply any amount paid in excess of the minimum payment using one of the following two methods: (1) to the balance with the highest APR first and any remaining portion to other balances in descending order of APR (high-to-low method), or (2) among the balances in the same proportion as each balance bears to the total balance (*pro-rata* method). This new rule was designed to reverse the current industry practice where payments are first allocated to balances with the lowest APR.
3. ***Prohibitions on Raising Interest Rates on Outstanding Balances.*** The Final Rules bar financial institutions from raising interest rates on outstanding debt, except under certain conditions, such as when a promotional rate has expired (provided that the expiration period and increased rate were disclosed at the account opening) or when the cardholder's payment is delinquent.
4. ***Prohibitions on "Double-Cycle Billing."*** The Final Rules prohibit financial institutions from imposing finance charges based on prior billing cycles when calculating charges for the current billing cycle.
5. ***Limitations on Fees/Security Deposits Charged to the Account for the Issuance of Credit.*** The Final Rules prohibit financial institutions from charging account fees or security deposit fees for simply opening an account or issuing credit, if those fees or deposits utilize a majority of the customer's available credit. In addition, institutions are required to spread any fees or deposits in excess of 25 percent of the credit limit over no less than the first six months rather than charging them as a one-time lump sum.

The Agencies did not adopt all of the provisions proposed in May 2008. For example, the Agencies decided not to include in the Final Rules a requirement that creditors disclose in a solicitation the factors that determine whether the consumer will qualify for the lowest APR and highest credit limit advertised. Although the Final Rules do not require such disclosures, the failure to make such discloses nevertheless could be deemed by the FTC to be an unfair or deceptive practice.

SUMMARY OF REGULATION Z FINAL RULE

The Final Rules also amend Regulation Z to simplify certain disclosures that consumers receive in connection with credit card accounts and other revolving credit plans, other than home-equity lines of credit. Key provisions of these amendments, which are also effective July 1, 2010, include the following:

1. ***Applications and Solicitations Disclosures.*** The Final Rules contain format and content changes designed to make credit and charge card application and solicitation disclosures more meaningful and easier for consumers to use. The content changes include a required disclosure that penalty rates may be in effect, a shorter disclosure about variable rates, new descriptions on grace periods, and a reference to consumer education materials on the Board's website.
2. ***Account Opening Disclosures.*** The Final Rules require disclosure of certain basic fees and terms at account opening in a summary table, which is substantially similar to the table required for credit and charge card applications and solicitations. The table required at account opening includes more information than the table required at application, such

in or affecting commerce within the meaning of section 5(a) of the FTC Act. *See* 15 U.S.C. §§ 57a(f)(1), 45(a). A secondary basis for the OTS' rule is the Home Owners' Loan Act, 12 U.S.C. § 1461 *et seq.*

as a disclosure of whether there is a grace period for all features of an account. To reduce the compliance burden, the Final Rules allow creditors to provide the more specific and inclusive account-opening table at application in lieu of the table otherwise required at application, commonly referred to as the "Schumer Box." In addition, creditors may continue to provide other account-opening disclosures, aside from the fees and terms specified in the new table.

3. ***Periodic Statement Disclosures.*** The Final Rules revise the requirements for disclosures on periodic statements, primarily by changing the format requirements, among other things, to group fees and interest charges together. They also eliminate the requirement to disclose an "effective APR," because consumers did not understand that term, and require disclosure of the effect of making only the minimum required payment on the time to repay balances.

4. ***Change-in-Terms Notices.*** The Final Rules expand the circumstances under which consumers must receive written notice of changes to account terms and require creditors to provide a summary table of such changes in a periodic statement. They also increase the advanced notice required before a term can be changed from 15 days to 45 days.

5. ***Advertising Provisions.*** The Final Rules permit advertisements to refer to a rate as "fixed" only if a time period is specified for which the rate is fixed and during such time period the rate will not increase for any reason. A time period need not be specified as long as the rate will not increase for any reason while the plan is open.

SUMMARY OF REGULATION DD FINAL RULE

The Final Rules also amend Regulation DD to address depository institutions' disclosure practices related to overdrafts. Key provisions of these amendments, which are effective January 1, 2010, include the following:

1. ***Disclosure of Aggregate Overdraft Fees.*** The Final Rules require all depository institutions to disclose on periodic statements the aggregate dollar amounts charged for overdraft fees and for returned items for both the statement period and for the year-to-date. Prior to the Final Rules, the requirement to disclose aggregate amounts applied only to institutions that promote or advertise the payment of overdrafts.

2. ***Disclosure of Balance Information.*** The Final Rules require institutions that provide account balance information through an automated system, such as via ATM, to provide a balance that does not include additional funds that may be available to cover overdrafts.

SUMMARY OF REGULATION E PROPOSED RULE

Along with the Final Rules, the Agencies proposed amendments to Regulation E that would require consumer choice with respect to overdraft protection programs and would prohibit unfair fees for debit holds. The proposed rule replaces previously proposed amendments under Regulations AA and DD addressing overdraft services. Comments on the proposed rule are due 60 days after the date of publication in the federal register. The proposed rule would apply to all depository institutions, including state-chartered credit unions. Key provisions of the proposed rule include the following:

1. ***Consumer Choice Regarding Overdraft Protection Programs.*** The proposed rule solicits comments on two alternative approaches to providing consumers a choice regarding the payment of ATM and one-time debit card overdrafts by their financial institutions.

   - Opt-out: Under one approach, financial institutions would be prohibited from assessing fees for paying an overdraft unless they provide the consumer with notice and a reasonable opportunity to opt out of the institution's overdraft service, and the consumer does not opt out.
   - Opt-in: The second approach would prohibit a financial institution from imposing overdraft fees unless the consumer affirmatively consents to the institution's overdraft service.

2. ***Prohibitions on Unfair Fees for Debit Holds.*** Financial institutions would be prohibited from assessing an overdraft fee if the overdraft is caused solely by a hold on funds that exceeds the actual purchase amount of the transaction, unless the purchase amount alone would have caused the overdraft. The proposed rule provides a safe harbor that would allow an institution to assess an overdraft fee to the consumer's account in connection with a debit hold if the institution has adopted procedures and practices designed to remove the hold within a reasonable period of time.

IMPLICATIONS OF NEW REGULATORY REQUIREMENTS FOR FINANCIAL INSTITUTIONS

The regulatory and financial implications of the Final Rules are substantial. Although the Final Rules are not effective until the beginning and middle of 2010, as noted above, financial institutions would be advised to begin reviewing their current marketing, disclosure, and billing practices promptly, and making any necessary or appropriate modifications to ensure compliance with the Final Rules by their effective date. Given the scope of the amendments, it appears that financial institutions will have to commit significant resources to modifying many back-office functions. For example, periodic statements will either need to be generated more quickly, or else payment due dates will need to be extended to comply with the new prohibition on the treatment of a payment as late unless the financial institution has provided a reasonable amount of time for the consumer to make the payment, with each option carrying obvious operational and carrying costs to the industry. New requirements aimed at preserving the benefit to consumers of promotional rate balances and deferred interest programs will require modification of payment allocation algorithms. Similarly, interest-rate and fee calculation mechanisms will require reprogramming to ensure compliance with new regulations, such as the limitations on annual percentage rate increases on outstanding balances and the prohibition on "double-cycle billing." And, of course, disclosure materials likely will need to be reviewed and revised in response to changes required by the Final Rules summarized above. Industry participants also would be advised to assess the costs of making these changes and the extent to which those costs can be passed on to consumers.

Another aspect of the Final Rules that may prompt substantial changes to both industry practices and to those credit card issuers that issue subprime cards is the limitation on fees and security deposits charged to an account as part of the issuance of such credit cards. We understand that currently, many credit card issuers in the subprime market use a combination of account fees and/or security deposits to permit the extension of credit to riskier borrowers on terms commensurate with the risk posed by such lending. As a result of the new limits on the ability to collect up-front fees and deposits imposed by the Final Rules, these credit card issuers will need to reexamine the feasibility of extending credit to subprime borrowers, and ultimately may choose to spread the cost of such credit to other consumers.

In addition to the concrete expenses that the Final Rules will create, a number of legal implications must also be addressed during the implementation process. As the Agencies note in their commentary, a decision must be made as to whether states with more protective laws regulating similar practices should be eligible for exemption from the Final Rules as is the case under the FTC's Credit Practices Rules. Naturally, such an option would further add to the cost and complexity of compliance efforts for institutions operating in multiple states. Broader federal preemption issues will also surface as greater attention is focused on the Final Rules. Indeed, the Final Rules implicate the authority of the Agencies to directly regulate fees and expense charges in the absence of a federal usury statute. Additionally, although an obvious effort has been made to draft around this problem, it is unclear how to reconcile the provisions of the Truth in Lending Act (TILA) with parts of the proposed regulations. Specifically, TILA requires that if an issuer of credit provides a grace period in connection with a consumer credit card account, a periodic statement for the account must be mailed or delivered 14 days prior to the due

date. However, under the Final Rules, a 14-day advanced mailing is not only ineligible for the safe harbor, but might be deemed an unfair or deceptive act or practice.

AREAS FOR COMMENT ON PROPOSED AMENDMENTS TO REGULATION E

The Board included in the Regulation E proposed rulemaking numerous specific requests for industry comment. For example, the Board requested comment on the opt-out and opt-in proposals, including the costs and benefits of each proposal to consumers and financial institutions. It also requested comment on which approach (opt-out or opt-in) would be optimal for consumers and whether one approach may present unique operational or cost issues that would not be associated with the other approach. The proposed rule proposed to limit the scope of the proposed opt-out to ATM withdrawals and one-time debit card transactions, but the Board requested comment on whether the proposed opt-out should apply also to recurring debit card transactions and ACH transactions. In addition, the Board requested comments on the appropriate timeframe for a safe harbor, whether the regulation should require institutions to provide a toll-free telephone number to ensure consumers can easily opt out, and whether the regulation should provide examples of methods of opting out that would not satisfy the requirement to provide a reasonable opportunity to opt out, such as requiring the consumer to write a letter to opt out.

The Board also requested comment on the debit hold proposal, including the costs and benefits of the proposed rule to consumers and financial institutions and the appropriateness of the proposed safe harbor. Institutions should refer to the proposed rulemaking itself for the complete list of requested comments.

We would be pleased to assist financial institutions in reviewing and modifying their marketing, disclosure, and billing practices to ensure compliance with the Final Rules. We have extensive experience in the credit card regulatory area, and would be pleased to assist in assessing the impact of the Final Rules or the proposed rule on business practices. If you have questions about the Final Rules, please contact your Arnold & Porter LLP attorney, or:

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