Financial Institutions

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CLIENT ADVISORY ON NEW FEDERAL CREDIT CARD REGULATIONS

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Yesterday afternoon — December 18, 2008 — the Board of Governors of the Federal Reserve System ("Board"), in coordination with the Office of Thrift Supervision ("OTS") and the National Credit Union Administration ("NCUA") released long-awaited final amended credit card regulations.[1]

The new regulations prompted extraordinary interest from members of the credit card industry, consumer advocacy groups, and consumers, among others, triggering some 60,000 letters during the public comment period on the proposed draft version of the regulations released seven months ago.[2] Despite the record-setting number of comments, the final regulations are only modestly changed from the proposed rules. The new regulations become effective on July 1, 2010.[3]

The new rules are intended by the agencies to prohibit certain unfair or deceptive acts and to improve the disclosures consumers receive in connection with credit card accounts and other revolving credit plans; in the words of Board Chairman Ben Bernanke, to "establish a new baseline for fairness in how credit card plans operate."[4] While unfair or deceptive practices historically have been addressed through individual enforcement efforts against particular scofflaws, the regulations are notable in that they are directed in part at widely accepted credit card industry practices.

In fact, the approach taken in the final regulations represents a significant shift away from disclosure-based consumer protection and toward more direct regulation of credit card terms and conditions, a shift that likely forecasts a future trend in the regulation of consumer credit. This more proactive use of authority under the FTC Act by the regulators was prompted not only by the recent turmoil in financial markets and the broader economy, but also by key members of Congress and consumer groups, who pressured the Board to use its rulemaking authority more aggressively to protect consumers. That said, even these regulations may not be the final word on this subject; notwithstanding the new rules' sweeping reform of credit card industry

[1] The final regulations are being promulgated pursuant to authority given to the Board, OTS, and the NCUA under Section 18(f)(1) of the Federal Trade Commission Act ("FTC Act") to define and prohibit unfair or deceptive acts or practices under Section 5(a) of the FTC Act with respect to consumer credit cards. *See* 15 U.S.C. §§ 57a(f)(1), 45(a). The Board has also passed complementary regulations under Regulation Z (Truth in Lending Act) and Regulation DD (Truth in Savings Act), primarily dealing with new disclosure measures. Although rulemaking authority under the FTC Act is allocated to the Board, OTS, and the NCUA, enforcement authority under Section 18 of the FTC Act is spread among the Board, OTS, NCUA, and the Office of the Comptroller of the Currency ("OCC") and the Federal Deposit Insurance Corporation ("FDIC"). *See* 15 U.S.C. § 57a(f)(2)–(4).

[2] These comments are available for viewing on the Board's website at http://www.federalreserve.gov/newsevents/press/bcreg/20080502a.htm.

[3] *See* Unfair or Deceptive Acts or Practices (publication forthcoming in the Federal Register) (to be codified at 12 C.F.R. Part 227, Part 535, and Part 706), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20081218a2.pdf.

[4] *See* Statement by Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, *at* www.federalreserve.gov/newsevents/press/bcreg/bernanke20081218a.htm.

practices, we anticipate that even tougher credit card-related legislation is possible next year when the House and Senate reconvene. We will continue to follow and report on these developments as they unfold.

To briefly summarize, the key aspects of the final regulations include:

1. Prohibition on Rate Increases for Outstanding Balances

To date, standard credit card terms have allowed card issuers to raise interest rates not only prospectively, but also on current account balances. The credit card industry has used this flexibility to address the changing credit profile of consumers by raising rates to manage payment default risk. The final regulations significantly cut back on this former flexibility, permitting credit card interest rates to be raised on existing and future account balances only in limited circumstances, including when:

- a variable interest rate changes due to the operation of an index;
- a promotional rate expires or is lost, as long as the rate is not increased to a "penalty" rate;
- the minimum payment is not received within 30 days of the due date;
- after the first year, the credit card issuer provides the mandatory 45 days of notice of a rate change under the Truth in Lending Act;
- a consumer participating in a workout arrangement fails to abide by the conditions of the workout arrangement, the rate may revert to the pre-workout interest rate.

In making these changes, the regulations also end the practice of "universal default," in which interest rates could be increased in response to a borrower's payment history with unrelated bills or other credit cards.

This aspect of the final regulations is controversial; some industry observers are concerned that it may reduce the availability of low introductory rates that consumers potentially could lock-in for an extended period of time, or that it may result in higher rates for all consumers. Credit card issuers, industry groups, and the Office of the Comptroller of the Currency strongly opposed these measures when they were proposed in May 2008, contending that the measures undermine the ability of institutions to price credit cards according to current market conditions and consumer risks.

The foregoing restrictions on interest rate changes apply only to current account balances; credit card issuers are still permitted to raise interest rates prospectively, provided they satisfy the 45-day notice requirement for a rate increase, in accordance with the Truth in Lending Act.

2. New Payment Allocation Rules for Outstanding Balances

Many credit cards offer different interest rates for different portions of a customer's credit card balance. For example, low promotional rates are often given that apply only to balance transfers, while cash advances on the same credit card may be charged significantly higher rates of interest. A common industry practice has been to apply credit card payments to the low-interest portions of a credit balance first, resulting in a higher interest charge for consumers. The Board concluded through market studies that consumers had significant difficulty understanding how payments were allocated even with extensive information disclosures. The final regulations directly regulate the methods used to allocate consumer payments. Under the regulations, payments must be allocated to credit card balances using a prescribed method (or any other method that is no less

beneficial to consumers), including:

- Allocation of the entire payment to the credit balance with the highest interest rate; and
- Pro rata allocation of the payment to all portions of the consumer's credit card balance.

The proposed regulations would have prohibited the allocation of payments to discounted promotional rates until all other balances had been paid in full. In response to concerns that such an exception would significantly reduce or eliminate the offering of discounted rates, this provision was omitted from the final regulations.

3. Reasonable Amount of Time to Make Payments

The final regulations prohibit the treatment of payments as late unless the consumer has been given a reasonable amount of time to make the payment. The regulations include a "safe harbor" provision, treating the payment period as reasonable if the credit card issuer sends periodic statements at least 21 days prior to the payment due date.

Complementary regulations promulgated pursuant to the Truth in Lending Act buttress the "reasonable repayment" provisions, ensuring that creditors may not set cut-off times for mailed payments before 5 P.M. at the location specified by the creditor for receipt of the payment, and that if the due date for payment is a day on which the U.S. Postal Service does not deliver mail or the creditor does not accept mail, the creditor may not treat a payment received by mail the next day as "late" for any purpose, including imposing a "penalty" annual percentage rate, reporting the consumer to a credit reporting agency, or assessing a late fee for failure to make payment within the repayment period.[5]

4. "Two-Cycle" Billing Restrictions

The final regulations prohibit "two-cycle" billing, in which interest is charged on credit balances incurred during a previous billing cycle, even if that balance has been partially repaid within the repayment grace period. Under this now-prohibited method, when a consumer paid the entire account balance during one month, but carried a balance the following month, the credit card issuer calculated interest for the second month using the account balance for certain amounts of time in both the prior billing cycle and the current billing cycle.

5. Limitations on Fees/Deposits Charged for Subprime Credit Cards

Currently, some credit card plans for "subprime" borrowers require the financing of security deposits or fees for the issuance of a credit card. In the past, some subprime cards charged fees and deposits that consumed the majority of the available credit on the account. The new regulations prohibit account-opening or membership fees during the account's first twelve months that exceed 50% of the initial credit limit, and require that security deposits and fees exceeding 25% of the credit limit be spread over the first year. Any fees that exceed 25% of the available credit limit (up to the 50% cap), must be spread evenly over at least five billing cycles. This proposal is expected to impact the availability of credit for subprime borrowers.

[5] *See* 12 C.F.R. 226.10(b), (d).

6. Key Provisions Omitted from Final "Unfair and Deceptive Practices" Rules

Several other provisions included in the proposed regulations were omitted from the final unfair and deceptive practices regulations, including:

- **Qualification Disclosure Rules for Firm Offers of Credit**. The proposed regulations would have required disclosure of the factors that determine eligibility for the most advantageous credit terms when cards marketed to consumers advertise multiple APRs or credit limits. Although the Board has not labeled the lack of qualification disclosures as "unfair or deceptive" under the FTC Act, the Board has passed new final regulations published under the Truth in Lending Act that will require substantial disclosure of the qualifications for various offered credit terms.[6]
- **Prohibition on Fees for Exceeding Credit Limits Caused by a "Hold**." The final regulations omitted a provision in the proposed regulations that would have prohibited fees being charged when a customer exceeds the account credit limit solely due to a "hold" on the available line of credit.
- For both **Qualification Disclosure** and **"Hold" Fee Overdraw Limitations**, the Agencies intend to rely on case-by-case supervisory and enforcement actions in circumstances where these practices raise concerns of unfairness or deception.
- **Restrictions on the Overdraft Services Provided for Consumer Checking Accounts.** The Board, OTS and NCUA opted to postpone promulgating these regulations in response to comments that overdraft services would be more appropriately addressed under the Board's authority pursuant to the Electronic Funds Transfer Act. The proposed regulations had included provisions restricting overdraft charges for consumer checking accounts, permitting consumers to opt out of overdraft services. Now, separate proposed regulations addressing overdraft services on deposit accounts and debit holds are awaiting public comment.

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Attorneys in Covington's Financial Institutions Group have advised many clients on recent financial services and banking developments. The Financial Institutions Group's expertise derives from advising clients on the impact of such developments over the course of the past three decades. Please do not hesitate to contact any member of our Financial Institutions Group, including the undersigned, should you have any questions.

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[6] *See, e.g.*, 12 C.F.R. § 226.5a(b)(1)(v)