

## Proposed Rule Amending Regulation Z Truth in Lending Act Effective August 22, 2010

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On March 3, 2010, the Federal Reserve Board ("*Board*") proposed a rule to amend Regulation Z as the third stage of the Board's implementation of the Credit Card Accountability Responsibility and Disclosure Act of 2009 ("*Credit Card Act*"). The proposed rule implements the new Sections 148 and 149 of the Truth in Lending Act ("*TILA*") to address (i) the reasonableness and proportionality of penalty fees and charges, and (ii) the re-evaluation of rate increases by credit card issuers. The Board is seeking comments regarding various aspects of this proposed rule.

### **Reasonableness and Proportionality of Penalty Fees and Charges**

The proposed rule implements new TILA Section 149 by providing as a general rule that the dollar amount of the fee a card issuer imposes on customers for violating account terms or other requirements of the account must either: (i) represent a reasonable proportion of the total costs incurred by the card issuer as a result of that type of violation or (ii) be reasonably necessary to deter that type of violation.

Fees subject to these limitations include fees for late payment, returned payment or an over the limit transaction. Balance transfer fees, cash advance fees, foreign transaction fees, fees for reissuing a lost or stolen card, fees for expedited payment, insurance fees and annual fees are not subject to the rule.

### **Penalty Fee Based on Costs**

The first part of the general rule provides that a card issuer may consider, in determining the reasonable proportion of total costs: (i) the number of violations of a particular type experienced by the card issuer during a prior period and (ii) the costs incurred during that period for those violations.

- For late payment fees, a card issuer may consider costs associated with the collection of late payments, such as the cost of notifying consumers, resolving delinquencies, establishment of workout and temporary hardship arrangements, as costs incurred by

the card issuer, but is prohibited from including losses and related costs (such as reserves) in its determination.

- For returned payment fees, a card issuer may consider costs associated with processing returned payments, reconciling the card issuer's systems and accounts and notifying the consumer and arranging for a new payment.
- For over the limit fees, the card issuer may consider costs associated with notifying the consumer and arranging for payments to reduce the balance below the credit limit.

### **Penalty Fee Based on Deterrence**

As an alternative to basing penalty fees on costs, card issuers are permitted to charge a penalty fee if the card issuer has determined that the fee imposed is reasonably necessary to deter the type of violation for which the fee is imposed. The card issuer is required to consider the conduct of the consumer in making this determination, but the card issuer is not required to establish that a specific penalty fee would deter violations by a specific consumer. The proposed rule requires a card issuer to support its penalty fees based on deterrence on an empirically derived, demonstrably and statistically sound model that reasonably estimates the effect of the amount of the fee on the frequency of the violations.

### **Safe Harbor**

The Board proposes to establish a safe harbor for a penalty fee limited to the greater of: (i) a specific dollar amount, or (ii) 5% of the dollar amount associated with the violation of the account terms or other requirements (up to a specific dollar amount). The Board did not provide the specific dollar amount limits associated with this rule and is soliciting comments on those amounts and on the safe harbor provision generally.

### **Re-evaluation of Penalty Fees**

Card issuers are required to impose penalty fees based on current cost or deterrence information. The proposed rule requires the card issuer to re-evaluate its determination under the cost or deterrence method at least once every twelve (12) months. If the card issuer concludes that a lower fee is appropriate, it must begin imposing the lower fee within thirty (30) days after completing the evaluation. If the card issuer concludes that a higher fee is justified, the card issuer may begin imposing the higher fee after complying with the notice requirements set forth in Section 226.9 on Subsequent Disclosures.

### **Disclosures**

The Board expects that implementation of the new rule will result in penalty fees based on a range of penalty fee amounts, rather than a specific amount, i.e., "up to \$\_\_." As a result, application and solicitation disclosures, account opening disclosures and periodic statement disclosures will change.

## **Prohibited Fees**

The proposed rule also prohibits certain type of fees. Prohibited fees include:

- fees based on violations of account terms that exceed the dollar amount associated with the violation at the time the fee is imposed;
- a late payment fee or a returned payment fee that exceeds the amount of the required minimum periodic payment on which the fee is based;
- a separate or an additional fee for a subsequent return of payment if the card issuer submits the original check for payment again;
- more than one over-the-limit fee per billing cycle;
- a fee for a transaction the card issuer declines to authorize;
- fees to close or terminate the account;
- fees for account inactivity; and
- multiple fees based on a single event or transaction.

## **Re-evaluation of Rate Increase**

To implement the new TILA Section 148, the proposed rule requires in the event a card issuer increases an interest rate (on or after January 1, 2009) based on the credit risk of the consumer, market conditions or other factors, the credit card issuer must: (i) notify the consumer forty-five (45) days in advance of the rate increase, and (ii) review accounts to which an increase has been applied at least every six months to assess whether factors have changed. If a review indicates changes in factors, a reduced rate, if appropriate, must be provided. In this case, the card issuer must reduce the rate not later than thirty (30) days after completion of the evaluation. The proposed rule does not require the card issuer to decrease the APR to the rate that was in effect prior to increase (unlike the rate increases for consumers more than sixty (60) days delinquent who have cured their default by making the first six (6) minimum monthly payments on time) and does not mandate a specific amount of reduction in rate.

## **Factors to be Considered**

The review need not be based on the same factors on which the rate increase was based. The card issuer, at its option, may base the re-evaluation on the factors the card issuer currently uses to determine APRs or the same factors on which the rate increased was based. The Board has not provided a list of particular factors the card issuer must use, or is prohibited from using, in the re-evaluation. The proposed rule also requires the card issuer to have reasonable written policies and procedures in place to conduct the re-evaluation.

## **Timing of Re-evaluation**

The proposed rule allows the card issuer to review changes in factors in all of its accounts at the same time every six months or once each six months on a rolling basis. The card issuer's obligation to review factors ceases if the issuer reduces the APR to a rate equal or less than the rate prior to the increase and thus, the review obligation may extend indefinitely into the future. Rates increased between January 1, 2009 and August 21, 2010 must be reviewed by February 22, 2011.

## **Disclosures**

When providing the notice of increased rate, the card issuer must include in the notice the principal reasons for the increase. Up to four reasons may be provided, but no minimum number of reasons are required. New Model Forms have been issued.

## **Exceptions to Re-evaluation Requirement**

The proposed rule does not apply to an APR increase due to an increase in the index by which a properly disclosed variable rate is determined or at the expiration of a specified time period, such as a promotional rate. In addition, the proposed rule does not apply to: (i) an APR increase after the expiration of the active duty exemption, and (ii) accounts charged off in accordance with loan-loss provisions.

## **Recommendation**

We recommend that financial institutions begin taking action toward understanding and making the policy, procedural and system changes necessary for compliance with the proposed rule that will become effective on August 22, 2010. More importantly, we strongly recommend that financial institutions review the impact of the proposed rule and submit a comment letter to the Board. Comments are due sixty (60) days after publication in the Federal Register. The proposed rule has not been published as of the date of this Client Alert.

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If you would like to discuss any of the issues addressed in this Client Alert or would simply like to find out more about Chapman, please contact Marc Franson, Heather Hansche, Scott Fryzel, David Worsley, Jeffrey Langer, Steve Tumblin, Kenneth Marin, Judy Chen or visit us at [chapman.com](http://chapman.com).

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