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FINANCIAL INSTITUTIONS LAW UPDATE

October 21, 2005

Regulation Z Open-End Credit Rules Comment Period Reopened

On October 11, the Board of Governors of the Federal Reserve System published its second advance notice of proposed rulemaking (ANPR) regarding the open-end credit rules under Regulation Z, which implements the Truth in Lending Act (TILA). As part of its periodic review of Regulation Z, the Board published the first ANPR addressing the open-end credit rules in December 2004 and sought public comment on a variety of issues relating to the format and content of open-end credit disclosures and the substantive protections provided under Regulation Z. The comment period for that ANPR closed last March, but, less than a month later, President Bush signed into law the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the Bankruptcy Reform Act). Although primarily aimed at addressing abuses of the bankruptcy process, the Bankruptcy Reform Act also contained several provisions amending TILA to require new open-end credit disclosures and directing the Board to issue regulations implementing those amendments and to develop model forms and guidance. The latest ANPR supplements the one issued by the Board last December and seeks data or comment on specific issues relating to the TILA amendments in the Bankruptcy Reform Act. The comment period closes on **December 16, 2005**.

The TILA amendments under the Bankruptcy Reform Act are an improvement over the California "min pay" legislation that led to successful preemption litigation. But the subject is a very complex one; any disclosures are susceptible to misunderstanding, and there are a number of potential mistakes that could be made by the Board, creditors, consumers and the courts. The Board's recent ANPR identifies many of the complexities, but not, by any means, all of them. By submitting comments in response to the ANPR, creditors have an opportunity to provide input to the Board about the practical impact, costs and advisability of the various disclosure requirements and approaches under consideration. However, given the complexity of the issues, it seems likely that more communication with the Board will be needed in addition to formal responses to the ANPR.

Bankruptcy Act Amendments Rolled into Ongoing Regulation Z Review

The Bankruptcy Reform Act contains no statutory deadline for implementing the new TILA regulations; however, it does state that the Board should issue certain model forms and guidance regarding the "clear and conspicuous" standard set forth in certain provisions of the Act within

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six months of the Act's enactment (by October 20, 2005). In the ANPR, however, the Board states that the six-month period provides too little time to develop and seek public comment on the underlying substantive disclosures that are subject to the guidance and precludes effective consumer testing of the proposed new disclosures.

Rather than release model forms or guidance regarding the "clear and conspicuous" standard before issuance of the substantive regulations implementing the standard, the Board has elected to delay release of the model forms and guidance and to fold its implementation of the Bankruptcy Reform Act into its broader Regulation Z review. The Board claims that this will reduce the burden on creditors of complying with two separate waves of regulations, one implementing the Bankruptcy Reform Act and another implementing changes made as part of the periodic Regulation Z review; by issuing one set of regulations, creditors can adopt all of the necessary changes to their system at one time. In the meantime, absent new guidance regarding the "clear and conspicuous" standard under the new TILA provisions in the Bankruptcy Reform Act, the current standard set forth in Regulation Z will apply to all TILA disclosures, including those required under the Bankruptcy Reform Act, until a new standard is adopted by the Board after notice and comment in connection with the integrated Regulation Z review.

According to the Board, a primary goal of the integrated Regulation Z review is to improve the effectiveness and usefulness of TILA's open-end credit disclosures. Toward that end, the review will consider how the content of disclosures might be simplified to address concerns about "information overload" and alternatives for improving the format of disclosures. In addition to seeking comment on these and other areas, the Board has stated that it intends to use consumer testing and focus groups to test the effectiveness of any proposed revisions.

ANPR Contains Specific Questions Seeking Comment and Data

The Bankruptcy Reform Act contains a number of provisions amending TILA and addressing: (1) minimum payment warnings; (2) introductory rate offers; (3) Internet solicitations; (4) late fees; (5) high loan-to-value mortgage credit; and (6) account termination. As described below, the ANPR seeks comment and data regarding each of these six areas.

1. Minimum Payment Warnings

The Bankruptcy Reform Act amends Section 127(b) of TILA to require creditors that extend open-end credit to provide on the front of each periodic statement in a prominent location a standardized warning about the effect of making only minimum payments, including (1) a warning indicating that making only the minimum payment will increase the amount of interest the consumer pays and the time it takes to repay the consumer's balance; (2) a hypothetical example of how long it would take to pay off a specified balance; and (3) a toll-free telephone number that consumers can call to obtain an estimated repayment period for their actual account balance if only minimum payments are made. Alternatively, a creditor may use a toll-free telephone number to provide the *actual* number of months that it will take consumers to repay their outstanding balances. A creditor that chooses this option does not need to include a hypothetical example on its periodic statements, and, while the applicable toll-free number still must be disclosed on the periodic statement, it need not be located on the front of the statement.

Exemptions from Minimum Payment Disclosures. The Bankruptcy Reform Act requires the above disclosures for all open-end credit accounts. However, relying on its broad authority to grant exceptions from TILA's requirements, the Board seeks comment on whether it should grant exemptions from the minimum payment disclosure requirements under certain circumstances such as:

- For certain types of transactions or accounts for which the minimum payment disclosures may not be appropriate (for example, HELOCs with fixed repayment periods or reverse mortgages with unknown payment dates);[1] and
- For certain accountholders, regardless of the type of account (for example, an exemption for consumers who typically (1) do not revolve balances; or (2) make monthly payments that regularly exceed the minimum payment).

In addition, the Board seeks comment on how the minimum payment disclosures should be implemented for open-end credit plans that also allow extensions of credit that are structured like closed-end loans with fixed repayment periods and payment amounts (e.g., loans to finance the purchase of motor vehicles or other "big-ticket" items).

Hypothetical Examples for Periodic Statements. There are two hypothetical minimum payment period examples set forth in the Bankruptcy Reform Act—an example based on a typical 2% minimum payment[2] and one based on a typical 5% minimum payment.[3] Both assume an interest rate of 17 percent—but creditors are free to substitute an example based on an interest rate that is greater than 17 percent. The hypothetical example that creditors must disclose on periodic statements varies:

- Creditors that require a minimum monthly payment of four percent or less of the account balance must use the 2% example;
- Creditors that require a minimum monthly payment of more than four percent of the account balance must use the 5% example (or may opt instead to disclose the statutory 2% example);
- Creditors that are subject to FTC enforcement with respect to TILA are required to disclose the 5% example regardless of their actual minimum payment requirements.

The Bankruptcy Reform Act requires the Board to periodically recalculate, as necessary, the interest rate and repayment period required in the hypothetical examples. According to the Board, it has collected data that indicates that the average APR charged by commercial banks on credit card plans in May 2005 was significantly lower than the statutory example of 17 percent. Specifically, the Board's data showed an overall average APR of 12.76 percent and, if only accounts that were assessed interest are considered, an average APR of 14.81%. In light of this discrepancy, the Board requests comment on whether the 17 percent APR used in the statutory example should be adjusted

1. In the ANPR, the Board noted that much of the legislative history regarding the minimum payment disclosures centered on credit card accounts and revealed a principal concern that consumers may not be fully aware of how long it takes to pay off their credit card accounts if only minimum monthly payments are made. The Board further noted that this concern may not apply to certain types of open-end credit accounts such as those with fixed repayment periods (e.g., HELOCs) or those with unknown payment dates (e.g., certain reverse mortgages). In light of this, the Board requested comment on whether a complete or partial exemption from the minimum payment disclosure requirements should be granted to these or other types of open-end credit transactions or accounts. (A partial exemption could, for example, exempt a creditor from disclosing the hypothetical example and the toll-free telephone number on periodic statements but still require a standardized warning indicating that making only the minimum payment will increase the amount of interest the consumer pays.)

2. That example states: "For example, making the typical 2% minimum payment on a balance of $1,000 at an interest rate of 17% would take 88 months to repay the balance in full."

3. That example states: "Making a typical 5% minimum monthly payment on a balance of $300 at an interest rate of 17% would take 24 months to repay the balance in full."

and, if so, what criteria should be used in making the adjustment.

In addition, the Board noted that the hypothetical examples may be more appropriate for credit card accounts than other types of open-end credit accounts. In light of this, the Board seeks comment on whether it should consider revising the account balance, APR or "typical" minimum payment percentage used in examples for open-end accounts other than credit card accounts. The Board also requests comment on whether the term "typical" should be deleted from the hypothetical example to avoid misleading consumers.

Assumptions Used to Calculate the Estimated Repayment Period for Purposes of the Toll-Free Telephone Number. The Bankruptcy Reform Act requires open-end creditors to provide a toll-free telephone number on periodic statements that consumers can use to obtain the estimated period to repay the consumer's outstanding balance if the consumer pays only the minimum monthly payment.[4] To facilitate this, the Act requires the Board to create tables that estimate the approximate repayment periods. The Board has stated that it plans to develop formulas that can be used to generate the required tables and that can also be used to facilitate the use of automated systems to provide the required disclosures. Copies of the tables that can be generated using the formulas will also be made available by the Board on request.

In the ANPR, the Board notes that, in calculating the estimated repayment periods, assumptions must be made regarding certain factors, such as the balance calculation method, grace period, residual finance charge, interest rate and outstanding balance, and minimum payment formula. With respect to the first three categories, the Board proposes using the same assumptions used in creating the statutory hypothetical examples above:

- **Previous-Balance Balance Calculation Method.** The statutory hypothetical examples use the previous-balance method (which calculates the finance charge based on the entire account balance as of the first day in the billing cycle) rather than the average daily balance method despite the fact that the average daily balance method is more commonly used by creditors. The Board explains that this choice was made because additional assumptions would be required in order to use the average daily balance method, including assumptions regarding the length of each billing cycle and the date during each cycle that a consumer's payment is made.
- **No Grace Period.** The hypothetical examples assume that no grace period applies to any portion of the balance.
- **No Residual Interest.** In order to have a finite solution to the repayment period calculation, the statutory examples assume that no additional transactions occurred after the end of the billing cycle, that the account balance will be paid in full, and that no additional finance charges will be applied to the account.

The Board seeks comment on each of the above three assumptions, whether these assumptions should be used in creating the formula used to estimate repayment periods, and, if not, what other assumptions should be used and why.

4. The required toll-free telephone number can be a telephone number established and maintained by the creditor or by a third party for use by the creditor or multiple creditors. In addition, the Board is required to establish and maintain for two years a toll-free telephone number for use by customers of depository institutions with assets of $250 million or less, and the FTC must maintain a toll-free telephone number for creditors other than depository institutions. The toll-free number may connect consumers to an automated device through which they can obtain repayment information, provided that consumers whose telephones are not equipped to use the automated device are given the opportunity to be connected to an individual from whom the information may be obtained.

With respect to the last two categories—interest rate and minimum payment amount—the issues are more complex. As an initial matter, the Board notes that with respect to the toll-free numbers set up by the Board and the FTC, information about the consumers' account terms must come from the consumers directly because the information is not otherwise available to the Board or the FTC. With respect to the outstanding account balance, this does not pose a problem; the amount appears on consumers' monthly statements. However, consumers may be less able to provide information regarding the applicable interest rate and minimum payment requirement.

- **Interest Rate.** The hypothetical examples assume that a single interest rate applies to a single balance. However, in reality, open-end credit accounts, especially credit card accounts, can have multiple APRs (e.g., for purchases, cash advances, balance transfers and promotional rates). The Board seeks data regarding what proportion of credit card accounts accrue finance charges at more than one periodic rate and whether account balances typically are distributed in a particular manner (e.g., with the greater proportion of the balance accruing finance charges at a specific rate). The Board also seeks comment on the best approach for applying APR information to estimate the repayment period. In the ANPR, the Board sets forth the following possible approaches: using the actual individual APRs for each portion of the account balance;[5] choosing one APR applicable to the account and applying it to the entire account balance; using a formula that incorporates multiple APRs applicable to the account and assumptions about how those APRs should be weighted; and providing a range for the estimated repayment period based on the repayment periods generated by applying the lowest and highest APR applicable to the account to the entire account balance. In addition, if an approach uses multiple APRs, the Board seeks comment on what assumptions should be made regarding how consumers' payments are allocated to different balances (e.g., should it be assumed for purposes of the repayment period formula that payments always are allocated first to the balance carrying the lowest APR?).

- **Minimum Payment.** The Board seeks comment on alternative approaches to address how minimum payment requirements should be factored into the formula used to estimate repayment periods. The ANPR sets forth three possible approaches: using the creditor's actual minimum payment formula;[6] using the minimum payment dollar amount for

5. Although periodic statements must disclose all APRs applicable to an account, they are not required to indicate the portion of the account balance subject to each individual APR. The Board seeks comment on whether it should require creditors to disclose on periodic statements the portion of the ending balance that is subject to each APR for the account and the additional compliance cost of such a requirement. As an alternative to requiring disclosure on the periodic statement, the Board seeks comment on whether creditors should be required to program, or be provided the option of programming, their systems to calculate a consumer's repayment period based on the APRs applicable to the consumer's account balance and the additional compliance cost of such a requirement or option.

6. Using the creditor's actual minimum payment formula would result in the most accurate estimate; however, the exact formulas can vary among creditors and accounts, and consumers are unlikely to know what formula is used. Periodic statements do not disclose the formula, and, even if they did, the formula could be sufficiently complex that consumers would be unable to use it for purposes of obtaining the estimated repayment period using the toll-free call.

a particular billing cycle;[7] and selecting a "typical" minimum payment formula.[8] In addition, the Board seeks input on how to apply these approaches to creditors' own toll-free number systems.[9]

In light of these variables, the Board identifies and seeks comment on three basic approaches for developing a system to calculate estimated repayment periods for consumers who call the toll-free telephone number. Those approaches are:

1. Prompting consumers to provide an account balance, a minimum payment amount and APRs in order to obtain an estimated repayment period. To the extent that minimum payment and APR information is not adequately disclosed on periodic statements, the Board could either require additional disclosures or develop a formula that makes assumptions about these variables for a "typical" account.

2. Prompting consumers to input information, or using assumptions based on a "typical" account to calculate an estimated repayment period *but also giving creditors the option* to input information from their own systems regarding consumers' account terms.

3. Prompting consumers to provide their account balance, but *requiring* creditors to input information from their own systems regarding the account's minimum payment requirement and the portion of the balance subject to each APR.

The Board also seeks comment on whether there are specific alternative approaches it should consider. In developing a system, the Board has stated that it will consider the complexity of the approach and the resulting compliance burden as well as the accuracy and usefulness of the estimates that would be produced. In addition, the Board has asked whether there are alternative ways it should consider for creditors to provide repayment period disclosures other than through toll-free telephone numbers. For example, the Board noted that it could encourage creditors to disclose the estimated or actual repayment period on periodic statements and could exempt creditors who do so from the requirement to maintain a toll-free telephone number. The Board concludes that such disclosure would simplify the process for consumers and possibly for creditors, and it seeks comment regarding what difficulties creditors would have in making such

7. Using the dollar amount for any particular billing cycle would overstate the minimum payment amount in the succeeding months because the account balance would decline and, therefore, would underestimate the consumer's repayment period. This error would be compounded if the minimum payment dollar amount for the particular billing cycle used included non-recurring fees assessed in that cycle, such as late payment fees or over-the-credit-limit fees.

8. The Board seeks comment specifically on whether it should select "typical" minimum payment formulas for various types of accounts, and, if so, how the formulas should be determined. For the Board seeks comment on whether it would be appropriate to use a "typical" minimum payment formula for general-purpose credit cards that prevents prolonged negative amortization by requiring that minimum payments never be less than all finance charges plus one percent of the outstanding balance and whether there are other "typical" formulas for other open-end credit products. In addition, the Board seeks comment on whether, for purposes of identifying a formula, it should assume a "typical" minimum payment does not result in negative amortization and, if so, whether it should permit or require creditors to use a different formula to estimate the repayment period if the creditor's actual minimum payment requirement allows negative amortization.

9. In particular, the Board seeks comment on whether creditors should (1) be required to use an assumed typical formula created by the Board, (2) should have the option of using the Board's formula or using their own actual minimum payment formula or (3) should be required to use their own actual minimum payment formula. Additionally, the Board seeks information on the compliance costs that would result from requiring creditors to use their actual minimum payment formulas and whether those costs would be outweighed by the benefit of improving the accuracy of repayment estimates.

disclosures on the periodic statement. In addition, the Board seeks comment on what disclosures should be provided to consumers regarding the assumptions made in estimating the repayment period and when these disclosures should be provided (e.g., should some or all of the assumptions be disclosed on the periodic statement or orally when the consumer uses the toll-free telephone number?). The Board also asks whether it should issue model clauses for these disclosures.

In light of the many complexities and the imprecision involved in projecting a repayment period, a repayment period range may be preferable to a single, specific, estimated repayment period. The Board addresses this possibility only briefly in connection with the issue of identifying the applicable APR where multiple APRs apply to a single account. But resolving the issue over multiple APRs is only one benefit of repayment ranges. Such ranges would also help to avoid potential consumer confusion that could result from the provision of a single estimated repayment period that is based on assumptions and not the consumer's actual account terms. In addition, ranges would be particularly valuable to creditors to the extent that errors in estimating the repayment period could give rise to liability. This could be a particularly useful area for comment.

Option to Provide the Actual Number of Months to Repay the Outstanding Balance. The Bankruptcy Act allows creditors to maintain their own toll-free telephone number to provide customers with the *actual* number of months it will take to repay the customer's outstanding balance. Creditors who choose this option are not required to provide estimated repayment periods or to provide the disclosures described above. Instead, the creditor must include only the following statement on each periodic statement: "Making only the minimum payment will increase the interest you pay and the time it takes to repay your balance. For information, call this toll free number: ________ [blank space to be filled in by the creditor]." The Board seeks data regarding whether the actual repayment period can be determined based on information that is readily available to creditors using current accounting systems or whether new systems need to be developed and the costs of developing such systems. In addition, the Board seeks comment on what standards it should use to determine whether a creditor has accurately provided the actual repayment period, whether creditors should be permitted to use assumptions specified by the Board even if those assumptions do not match the terms on the consumer's account, and whether it should consider any safe harbors or a tolerance for error with respect to those calculations. Although not raised in the ANPR, creditors should also consider addressing whether errors or ambiguities in repayment period disclosures could give rise to suits under TILA for improper disclosure.

Guidance Regarding the Clear and Conspicuous Standard. The Board seeks comment regarding what guidance it should provide on the location or format of minimum payment disclosures, whether a minimum type size requirement would be appropriate, and what model forms or clauses the Board should consider.

2. Introductory Rate Offers

The Bankruptcy Reform Act requires additional disclosures on credit card applications and solicitations sent by direct mail or provided over the Internet that offer introductory rates or temporary annual percentage rates of interest. Specifically, credit card issuers must:

- Use the term "introductory" clearly and conspicuously in immediate proximity to *each* mention of the temporary APR in applications, solicitations, and all accompanying promotional materials.
- Disclose, in a prominent location closely proximate to the *first* mention of the introductory APR, the time period at the end of which the introductory APR expires and the go-to APR. The Board seeks comment on what standards it

should use in identifying one reference to the APR as the "first mention" (e.g., the APR using the largest font size or the one located highest on the page) and how to apply the "first mention" requirement with respect to direct mail offers that include several documents sent in a single envelope (e.g., identify one document as the "first mention" of the temporary APR or consider each document a separate solicitation). The Board also seeks comment on what guidance it should provide on how to disclose the go-to APR in the solicitation when the rate is set using risk-based pricing.

- Disclose, clearly and conspicuously in a prominent location on or with the application or solicitation, a general description of the circumstances that may result in revocation of the introductory rate (other than expiration of the introductory period) and the APR that will apply if the introductory APR is revoked. The Board seeks comment on what, if any, guidance it should issue regarding what constitutes a "general description" of the circumstances that may result in the revocation of the temporary APR.

The Board also seeks comment on what guidance it should provide on satisfying the various proximity and prominence requirements and the "clear and conspicuous" requirement as well as what model disclosures it should issue. Additionally, the Board asks for input regarding the extent to which guidance should differ for applications and solicitations provided by direct mail versus those provided electronically.

3. Internet Based Credit Card Solicitations

The Bankruptcy Reform Act also requires that Internet-based solicitations to open a credit card account make the same disclosures as applications or solicitations sent by direct mail, including Schumer box disclosures, but with two unique requirements: (1) disclosures must be "readily accessible to consumers in close proximity to the solicitation"; and (2) creditors must regularly update the disclosures to reflect current policies, terms and fees.

The Board notes that the Bankruptcy Reform Act requirement applies only to Internet-based *solicitations* which are defined by regulation to mean an offer to open an account without requiring an application. In light of this, the Board asks whether there is any reason for treating Internet applications differently from Internet solicitations. In addition, the Board notes that it issued interim final rules authorizing the use of electronic disclosures under Regulation Z in March 2001 and asks whether that guidance is sufficient or whether additional guidance is necessary regarding Internet compliance, including the meaning of "clear and conspicuous," "in close proximity," and "updated regularly" in the context of electronic disclosures.

4. Disclosures Related to Payment Deadlines and Late Payment Fees

If a late payment fee may be imposed on a consumer, the Bankruptcy Reform Act requires creditors to clearly and conspicuously disclose on the periodic statements the "date on which that payment is due or, if different, the earliest date on which a late payment fee may be charged" and the amount of the fee. The Board seeks comment on when, if ever, the date on which payment is due would be different from the earliest date on which a late payment fee may be charged. In addition, the Board again seeks comment on whether it should issue guidance regarding the clear and conspicuous requirement or should provide model disclosures. In addition, the ANPR addresses cut-off hours for payment posting. This is a topic that is not addressed by the Bankruptcy Reform Act but that was addressed in the Board's initial ANPR. The Board's decision to raise the issue again, now, is telling. In particular, the Board asks: "*If* the Board continues to allow creditors to establish reasonable cut-off hours, should the cut-off hour be disclosed on each periodic statement in close proximity to the payment due date." Many issuers have had class action litigation on this topic, and entered into settlements that (a) acknowledge the propriety of reasonable cut-off hours, and (b) deal with disclosure issues. The Board may not be aware of the extent to which this issue has been resolved by such settlements, nor of the extent of costs involved if the Board were to place restrictions on the establishment of cut-off hours. Although the Board particularly asks about disclosure, the lead-in to the disclosure question is an "if" that should not be passed over lightly in comments.

5. Disclosures for Home-Secured Loans That May Exceed the Dwelling's Fair-Market Value.

Under the Bankruptcy Reform Act, creditors extending open-end or closed-end credit secured by a home must provide additional disclosures where the loan exceeds or may exceed the fair-market value of the dwelling. Each print or Internet advertisement relating to such an extension of credit must include a clear and conspicuous statement that: (1) the interest on the portion of the extended credit that is greater than the fair-market value of the dwelling is not tax deductible for federal income tax purposes; and (2) the consumer should consult a tax adviser for further information about the deductibility of interest and charges. In addition, creditors are required to make the above disclosures at the time of application in cases where the extension of credit exceeds or may exceed the fair-market value of the dwelling. With respect to these requirements, the Board seeks comment on whether it should provide guidance interpreting when an extension of credit may exceed the fair-market value of the dwelling (e.g., should the disclosures be provided only when the new credit extended may exceed the fair-market value or should disclosures also be required if the new credit in combination with existing mortgages may exceed the dwelling's fair market value and should negative amortization be taken into account).

6. Prohibition on Terminating Accounts for Failure to Incur Finance Charges.

The Bankruptcy Reform Act prohibits a creditor from terminating an open-end consumer credit account before its expiration date solely because finance charges have not been incurred. The section does not prohibit a creditor from terminating an account for inactivity for three or more consecutive months. The Board seeks comment on what issues it should consider in providing guidance on when an account "expires" (e.g., should the expiration date on a credit card be considered the expiration date for the credit card account). The Board also seeks input on whether there are any issues it should consider that are applicable to open-end accounts other than credit card accounts and whether it should provide guidance on what constitutes "inactivity."

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Comments in response to the ANPR are due on or before **December 16, 2005**. Please contact us if you have any questions on the above summary or if you would like to discuss possible comments to be submitted in response to the ANPR.

New York:

Christopher R. Lipsett
212 230 8880
christopher.lipsett@wilmerhale.com

Washington:

David Medine
202 663 6220
david.medine@wilmerhale.com

Franca Harris Gutierrez
202 663 6557
franca.gutierrez@wilmerhale.com

Helen G. Foster
202 663 6892
helen.foster@wilmerhale.com

Natacha D. Steimer
202 663 6534
natacha.steimer@wilmerhale.com