Client Alert.

June 15, 2010

Federal Reserve Board Issues Final CARD Act Rule on Penalty Fees and Rate Reevaluations

Today, adding yet another layer of credit card regulation, the Federal Reserve Board ("Board") issued a final rule ("Final Rule") to implement the reasonable penalty fee and rate reevaluation provisions of the "Credit Card Accountability Responsibility and Disclosure Act of 2009" (the "CARD Act" or "Act").

PENALTY FEE PROVISIONS

The Final Rule prohibits an issuer from imposing a penalty fee for violating the terms or other requirements of an account, unless the dollar amount of the penalty fee is based on either the costs incurred by the card issuer as a result of that type of violation, as set forth in the Final Rule or, in the alternative, on the safe harbor amounts established in the Final Rule. The provision in the proposed rule that would have permitted an issuer to establish a penalty fee based on deterrence of violations does not appear in the Final Rule. The safe harbor amount for the first violation of a particular type is $25, and the amount for an additional violation of the same type (for example, a second late payment) during the next six billing cycles is $35.

As part of the safe harbor determination, there is no longer the requirement that an issuer determine the greater of the safe harbor amount or "five percent of the amount associated with the violation." Nevertheless, the Final Rule still prohibits the imposition of certain penalty fees, such as penalty fees that exceed the dollar amount associated with the violation, and precludes multiple penalty fees based on a single event or transaction. Thus, for example, if a consumer fails to make a $20 minimum payment by the due date, the late payment fee cannot exceed $20, even though the safe harbor would otherwise permit imposition of a $25 fee for the first violation and a $35 fee for a subsequent violation within the next six billing cycles.

Moreover, the Final Rule clearly applies to charge card accounts. In this regard, when a card issuer has not received the required payment for a charge card account that requires a consumer to pay the entire balance in full, the safe harbor late fee amount is 3% of the delinquent outstanding balance.

With respect to the cost determination method of establishing a late fee penalty, the Final Rule does not permit an issuer to consider "[l]osses and associated costs (including the cost of holding reserves against potential losses and the cost of funding delinquent accounts)" nor the "[c]osts 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." However, once a violation of the terms has occurred, the costs associated with preventing additional violations, for a reasonable period of time, can be factored into an issuer's cost determination.

As noted above, based on industry comments and further analysis, the Board has not adopted a deterrence standard as part of the Final Rule. Instead, the Final Rule incorporates deterrence into the revised safe harbor structure by allowing a card issuer to impose higher fees for repeated violations during a subsequent period of six billing cycles.

RATE REEVALUATIONS

The Final Rule requires an issuer that imposes a rate increase on a consumer based on credit risk, market conditions or other risk factors, to reevaluate the rate increase no less than once every six months and, if appropriate based on that review, to provide a rate decrease. An issuer is permitted to review either the same factors on which the rate increase was originally based, or to review the factors that the card issuer currently considers when setting rates applicable to new credit card accounts. The Final Rule, however, requires an issuer to conduct its first two reviews for rate increases imposed between January 1, 2009, and February 21, 2010, by using the factors the issuer currently considers with respect to new credit card accounts, except when the rate increase was based on a consumer-specific factor, such as delinquency.

The Board declined to adopt a specific time limit on an issuer's obligation to reevaluate rate increases. As a result, the Final Rule requires a card issuer to continue to review a consumer's account until the rate is reduced to the rate in effect prior to the increase. The Final Rule provides that "any reduction . . . shall apply to . . . any outstanding balances to which the increased rate . . . has been applied [and] new transactions that occur after the effective date of the rate reduction that would otherwise have been subject to the increased rate." For rate increases imposed on or after January 1, 2009, and prior to August 22, 2010, the first review for possible rate reductions must be conducted prior to February 22, 2011.

RELATED DISCLOSURE REQUIREMENTS

The Final Rule also modifies a number of disclosure requirements, including disclosures on applications and solicitations, account-opening forms, periodic statements and change-in-terms notices. As a result, issuers will be required to make additional revisions to their disclosures, credit agreements and operations less than 60 days after July 1, 2010, the effective date for other extensive and costly amendments to the Truth in Lending Act ("TILA") and Regulation Z.

The Final Rule is effective August 22, 2010. The mandatory compliance date for the change-in-terms notice requirements (Section 226.9), the penalty fee provisions (Section 226.52) and the rate reevaluation provisions (Section 226.59) is August 22, 2010. However, the mandatory compliance date for the penalty fee provisions included in applications and account-opening disclosures (Sections 226.5a and 226.6), periodic statements (Section 226.7), and other related disclosure requirements is December 1, 2010.

Below are links to the Board's press release and the Final Rule. If you have questions you may contact: Rick Fischer, at (202) 887-1566 and lfischer@mofo.com; Oliver Ireland, at (202) 778-1614 and oireland@mofo.com; or Obrea Poindexter, at (202) 887-8741 and opoindexter@mofo.com.

Press Release

http://federalreserve.gov/newsevents/press/bcreg/20100615a.htm

Final Rule

http://federalreserve.gov/newsevents/press/bcreg/bcreg20100615a1.pdf

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