Davis Wright Tremaine LLP
DEFINING SUCCESS TOGETHER

CARD Act Report Summary

December 23, 2015

The CFPB recently issued its 2015 CARD Act report on the consumer credit card market (the “Report”). The Report cites a significant amount of data with respect to the credit card market, including regarding use – e.g., number of accounts, total outstanding receivables, revolving balances, etc. – and the cost of credit – e.g., the Report contends that, without the CARD Act, consumers would have incurred $9 billion in overlimit fees and $7 billion of late fees. The Report also states that the CARD Act has been successful in reducing the incidence of so-called “back-end” pricing – e.g., interest rate repricings after account opening, penalty fees – and forced issuers to disclose most costs to the consumer up-front before account opening.

In addition to walking through various data, the Report expresses concerns with a number of issuer practices, including disclosure practices. These concerns are not concentrated in one particular section of the Report; rather, they’re scattered throughout. We believe that, considered together, these concerns provide a road map to practices that the CFPB is studying and will address through informal guidance, rulemaking or enforcement in the near term.

The summary below addresses the central areas of concern in the Report. These include: deferred interest products; the complexity of credit card rewards programs and the clarity of rewards program terms and conditions; the readability of credit card agreements; debt collection practices; and the implementation of new technologies in the credit card market.

Deferred Interest Products

The CFPB has expressed concerns with deferred interest programs (DIPs) because the cost of a deferred interest purchase is difficult for a consumer to estimate at the time the purchase is made; that is, the total cost of a purchase depends on future payment activity. This, the CFPB concludes, is a form of back-end pricing that the CARD Act was intended in part to prevent.

Moreover, the Report provides data showing that consumers with subprime credit tend to pay finance charges on deferred interest balances – i.e., fail to pay off the deferred interest balance in full by the promotion expiration date – far more frequently than consumers with higher credit scores. As a result, the CFPB contends that such consumers do not fully understand how DIPs work.

The Report further notes that, in many cases, consumers would be better off making a purchase with a general purpose credit card and revolving that purchase balance than using a DIP for the same purchase amount. The CFPB does not believe that current disclosure practices provide consumers the information they need to make such an informed decision.

Finally, the Report notes that, despite the CFPB’s having raised similar disclosure concerns in its 2013 CARD Act Report, DIP payoff rates have not improved. Taken together, these points suggest that the CFPB is considering taking significant steps to reform DIPs or perhaps to prevent them altogether (in that connection, the Report notes that prudential regulators, such as the Board of Governors of the Federal Reserve, have considered banning DIPs in the past).

Practices that the CFPB is closely monitoring in connection with DIPs include:

- Disclosures – The Report states that the majority of consumers who do not pay off a deferred interest balance by the promotion expiration date have at least 80% of such balance remaining and incur a substantial deferred interest charge at the end of the promotional period. Moreover, such consumers then tend to repay the promotional balance within two billing periods following expiration. The CFPB states that these patterns indicate that consumers do not understand how DIPs work. The Report suggests that enhanced disclosures might help consumers better understand the costs of DIPs.

- Ability to pay gap – The Report states that the CARD Act's "ability to pay" provisions do not require an issuer to determine that a consumer has the ability to pay off a deferred interest balance by the promotion expiration date. Moreover, some consumers may not understand that paying only the minimum payment each month is not sufficient to pay the deferred interest balance in full by the expiration date. Accordingly, such consumers will incur a lump sum interest charge at the expiration of the period. Moreover, consumers who pay only the minimum payment during a deferred interest promotional period may end up with debt after the promotional period that exceeds the amount of the promotional purchase, even if the card has not been used for any other purchases. Such "negative amortization" is a significant concern of the CFPB.

- Overlapping balances and payment allocation rules – The Report states that when consumers have both deferred interest and non-deferred interest balances on the same account, the CARD Act's payment allocation rules generally require that payments over the minimum payment be allocated to the highest interest balance first. This means that deferred interest balances are paid off at a slower rate than other balances, making it more likely that deferred interest balances will not be paid in full by the promotion expiration date. The Report suggests that payment allocation rules should be clearer to consumers. (These concerns appear to be consistent with an enforcement action entered against PayPal earlier this year arising out of unfair, deceptive, and abusive acts and practices in connection with DIPs. In particular, the CFPB alleged that the company engaged in abusive practices by: failing to provide sufficient information to consumers about how payments were allocated to and among standard and multiple DIP balances; applying payments in excess of the minimum payment proportionally to most, or all, promotional balances by default; representing to consumers that they could control the allocation of their payments when in reality they could not; and charging fees as a result of the default payment allocation method.)

Rewards Programs

The Report states that many consumers select a credit card based on rewards. Because rewards drive acquisitions, and because rewards are popular with consumers, the CFPB is concerned with deceptive and unfair practices arising out of rewards programs. From that perspective, the Report examines concerns arising out of each step of the rewards life cycle – i.e., marketing, earning, redemption, expiration and forfeiture, and account closure. The Report also raises concerns related to third party relationships, such as those with airlines and hotels.

Practices that the CFPB is closely monitoring in connection with rewards include:

- Marketing – The Report states that marketing of rewards cards tends to prioritize positive aspects of the rewards program, including acquisition bonuses, and overshadows important product terms, including pricing. Additionally, limitations on how rewards can be earned and redeemed, as well as expiration and forfeiture policies, are often not included in marketing materials. This appears to be a key concern of the CFPB, which warns that consumers may not be prepared for the "evaporation of expected and accumulated consumer value." The Report also specifically warns that the terms of acquisition bonuses requiring certain "spend" within a specific time period are not adequately disclosed and, in particular, cites continuing consumer confusion about the length of the period, what "spend" is considered eligible to earn the bonus, and whether and when the consumer has met the requirements for earning the bonus. Finally, the Report expresses a concern that full rewards terms and conditions are not available (or not obviously accessible) until after an application for a card is submitted.

- Availability, timing, and multiplicity of disclosures – The Report states that the delivery of rewards programs terms and conditions can be a source of confusion. Complete rewards program terms and conditions are sometimes located within some combination of documents, including marketing collateral, welcome kits with "plain English" rewards guides (i.e., summaries), card agreements, standalone terms separate from the card agreement, and online. Rewards "guides" can be misleading when they describe in plain English only certain, but not all, terms and when they do not clearly refer to the complete set of terms and conditions. Moreover, when provided a number of different documents, consumers may not know where to find specific terms.

- Vague terms – The Report states that rewards program terms regarding forfeiture, expiration, and account closure may not be clearly explained, particularly in marketing materials. For example, the Report identifies certain terms as vague when not accompanied by additional explanation. These terms include "inactivity" and "abuse" of an account. The Report also notes that only half of the rewards programs it reviewed permit consumers to pay to reinstate forfeited or expired rewards.

- Revision of terms – The Report states that rewards programs typically permit issuers to make unilateral revisions to rewards terms, without notice, including the right to revalue earned rewards, and identifies such practices as problematic. The Report further refers to rewards accounts as "something resembling a limited-purpose asset account."

- Earning rewards – The Report states that earning based on "spend" in categories – e.g., restaurants, travel – can be confusing to consumers when "spend" that appears to fit within a certain category, does not earn the offered accelerator (e.g., restaurants located in a supermarket) or when other limitations apply. Further, earn offers such as rotating accelerator categories, and requiring a consumer to opt in to receive accelerators for "spend" in a particular category, limit a consumer's opportunity to earn rewards by making earning rewards overly complicated. In addition, the Report unfavorably views rewards programs which incentivize revolving balances.

- Redeeming rewards – The Report states that certain qualifications to redeeming rewards, such as requiring a minimum redemption value, can come as a surprise to a consumer. Such limitations are often not disclosed in rewards program marketing; accordingly, marketing that highlights the ease of redemptions should be reconsidered. Moreover, any such qualifications and limitations should be made clear and conspicuous in terms and conditions.

- Third party rewards programs – The Report expresses concern that issuers do not have sufficient control over third party rewards programs – i.e., airline rewards – to address the issues raised above. Moreover, the report posits that consumers may not know whether to contact the issuer or the third party to resolve concerns relating to rewards.

Readability of Card Agreements and Disclosures

The Report provides data on the readability and length of consumer credit card agreements that are filed in the CFPB card agreement database as required by the CARD Act. In general, mass market card agreements have higher Flesch readability scores, lower Flesch-Kincaid grade levels, and are shorter than subprime card agreements. Notwithstanding that, the Report notes, subprime products with complex, difficult-to-read agreements are more frequently mailed to consumers with no college education.

With respect to disclosures, the CFPB is closely monitoring:

- Grace periods – The Report states that the concept of a grace period is complex and continues to be a challenge to explain to consumers. The Report reiterates that the impact of balance transfers on grace periods for new purchases, and the potential costs that can arise with subsequent account use, are a source of concern (as described by a 2015 CFPB Bulletin on the topic). Issuers that do not disclose such costs when marketing promotional offers may be engaging in "abusive" practices.

- Trailing interest – The Report states that trailing interest – interest charged after a balance has been paid in full – is not adequately explained to consumers, nor do agreements explain how consumers can avoid trailing interest.

- Minimum payments – The Report states that minimum payment formulas may not describe in sufficient detail how minimum payments are calculated. For example, some issuers require payment in full of amounts over the credit limit as part of the minimum payment but do not disclose as much in the minimum payment calculation formula. Additionally, agreements may be vague as to "how payments above the minimum payment are applied" when various balances on the account are subject to different interest rates.

- Variable rates – The Report notes that commonly used indexes for calculating variable rates, such as the Prime Rate, have not changed recently. As a result, consumers "may have come to expect that their existing balances, in general, will not be repriced." This means that many consumers will be faced with significant, unexpected costs when a variable rate increases. The Report does not prescribe a cure, but presumably disclosure would be helpful.

- Online disclosures – The Report states that many consumers who opt out of receiving paper statements also do not review statements online. Accordingly, the CFPB is concerned that such consumers do not see required statement disclosures, such as the minimum payment warning and the 36-month repayment disclosures. The Report encourages issuers to consider ways to include such disclosures, including statement disclosures required by Regulation Z, online, including on mobile devices. The Report also notes that consumers who review their accounts online without consulting statements might not be able to monitor for fraudulent transactions as effectively as those who review statements.

Debt Collection

The Report focuses on credit card debt collection activities and provides data on such practices. The Report notes in particular that, since the OCC issued guidance on debt sales, the volume of debt sale activity has decreased significantly. The Report warns that agreements between debt sellers and buyers must contain adequate representations and warranties regarding the accuracy and completeness of information provided to the debt buyer, including information enabling the buyer to validate the debt. In addition, agreements must contain representations and warranties that the seller has title to the accounts and that the seller has complied with all relevant consumer laws. Each of the foregoing must be unqualified – i.e., cannot be given "to the best of the seller's knowledge."

New Products and Innovations

The Report describes certain recent developments involving information security, mobile payments, and new products that compete with credit cards.

- Information security – The Report discusses recent high-profile data breaches involving credit card data and other credit card related fraud, and describes without judgment recent security innovations, including EMV chip cards, tokenization, and data encryption.

- Mobile payments – The Report discusses widely-known mobile payment innovations like Apple Pay, but notes that only a small number of transactions is initiated through mobile form factors and that the technologies are still young and under development. The CFPB intends to monitor the impact of mobile payments on consumers.

- New competitors – The Report identifies products that compete against credit cards, including installment loans made readily available at the point-of-sale, sometimes offered by non-bank entities. The CFPB intends to monitor the development and implementation of these products.