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FEDERAL RESERVE BANK OF PHILADELPHIA

Prepared for institutions supervised by the Consumer Compliance & CRA Unit

Interagency Guidance Issued on Unfair or Deceptive Acts or Practices by State-Chartered Banks

by Eddie L. Valentine, Supervising Examiner

On March 11, 2004, the Board of Governors of the Federal Reserve System (Board) and the Federal Deposit Insurance Corporation (FDIC) issued guidance outlining standards they will apply to determine when acts or practices by state-chartered banks are unfair or deceptive.[1] Such practices are illegal under section 5 of the *Federal Trade Commission Act* (FTC Act).

Purpose

To respond to questions raised by institutions under the agencies' supervision, the Board and the FDIC jointly issued a statement that provides guidance on steps that state-chartered banks can take to avoid engaging in unfair or deceptive acts or practices. The approach outlined in the statement is based on long-established standards used by the FTC to enforce section 5 of the FTC Act against non-bank entities.

The joint statement outlines standards for state-chartered banks that are consistent with the March 2002 standards articulated by the OCC for national banks in Advisory Letter 2002-3, *Guidance on Unfair or Deceptive Acts or Practices*,[2] and are guided by the Federal Trade Commission's December 1980 *FTC Policy Statement on Unfairness*[3] and October 1983 *FTC Policy Statement on Deception*[4]. These standards will be applied to determine when specific acts or practices by state-chartered banks are unfair or deceptive.

[1] The joint guidance *Unfair or Deceptive Acts or Practices by State-Chartered Banks* is available on the Board of Governors' website at <www.federalreserve.gov/boarddocs/press/bcreg/2004/20040311/attachment.pdf>.

[2] Advisory Letter 2002-3 is available on the OCC's web site at <www.occ.treas.gov/ftp/advisory/2002-3.doc>.

[3] The *FTC Policy Statement on Unfairness* is available on the FTC's web site at <www.ftc.gov/bcp/policystmt/ad-unfair.htm>.

[4] The *FTC Policy Statement on Deception* is available on the FTC's web site at <www.ftc.gov/bcp/policystmt/ad-decept.htm>.

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High Risk Areas

The guidance addresses areas with the greatest potential for unfair or deceptive acts or practices. These areas include advertising and solicitations, customer agreements and disclosures, loan servicing and collection practices, and managing and monitoring employees and third-party service providers.

Best Practices

In response to questions raised by the institutions under the agencies' supervision, the joint statement also provides guidance on best practices that state-chartered banks are encouraged to use to avoid engaging in certain unfair or deceptive acts or practices.

State-chartered financial institutions should review how they plan to implement procedures to conform to the joint guidance on unfair or deceptive acts or practices.

It outlines specific measures that banks should consider incorporating into their policies and procedures to protect consumers and minimize their own risk.

To avoid engaging in unfair or deceptive activity, institutions are encouraged to adopt the following practices.

- Review all promotional materials, marketing scripts, customer agreements, and disclosures to ensure that they fairly and accurately describe the terms, benefits, and material limitations of the product or service being offered. Ensure that these materials do not rely on fine print or inconspicuous disclosures to correct potentially misleading or unclear "headlines."
- Be sensitive to the importance of clear and accurate disclosures when marketing credit and other products and services to the elderly, the financially vulnerable, and other consumers who may not be financially sophisticated.
- When using such terms as "pre-approved" or "guaranteed," clearly and conspicuously disclose any limitations or conditions on the offer.
- When making any claims about the amount of potential credit that an applicant may receive, represent accurately and completely the amount of usable credit that will be available after fees assessed at account opening are billed to the account.
- Implement and maintain effective risk and supervisory controls to select and manage third-party vendors and servicers. Ensure that employees and third parties that market bank products or service loans are adequately trained.
- Review compensation arrangements with employees and third parties to ensure that they do not create unintended incentives to engage in unfair or deceptive practices.
- Ensure that loan servicing procedures are in place and are followed so that consumers' payments are credited in a timely manner. Consumers should be informed when regular monthly payments are applied to fees, penalties, or other charges instead of being applied to principal and interest.
- Disclose a telephone number or address (including e-mail or web site addresses, as applicable) that consumers may use to file any complaints, and maintain appropriate procedures for resolving complaints. Review consumer complaints to identify practices that have the potential to mislead consumers.

Conclusion

State-chartered financial institutions should review how they plan to implement procedures to conform to the joint guidance on unfair or deceptive acts or practices. Adopting the suggested best practices might be the easiest way to effect compliance and minimize risk. As always, staff will also need to be trained to ensure their understanding of the guidance.

If you have any questions regarding this article, please contact Supervising Examiner Eddie L. Valentine (eddie.valentine@phil.frb.org) or Robin P. Myers, Consumer Compliance/CRA Examinations Unit Manager, (robin.myers@phil.frb.org) through the Regulations Assistance Line at (215) 574-6568.

Debt Cancellation Contracts and Debt Suspension Agreements: Consumer Products Raise Industry Interest—Part I

by Frederick W. Stakelbeck, Jr., Staff and Career Development Coordinator and Anne Stanley, Executive Assistant to the President

Credit card issuers increasingly rely on supplemental product offerings to provide alternative revenue sources and thereby enhance profitability. Prime examples of such products are debt cancellation contracts (DCCs) and debt suspension agreements (DSAs). The topic of DCCs and DSAs has relevance to the Federal Reserve Bank of Philadelphia in that several leading credit card issuers maintain operations in the Third Federal Reserve District. In addition, the Board of Governors of the Federal Reserve System has indicated that anecdotal evidence gathered suggests that the sale of DCCs and DSAs in lieu of credit insurance has increased.

The following is the first installment of an informational paper that was written to facilitate an understanding of DCCs and DSAs. Part I of the article provides a general overview, new definitions, and common features and requirements, and discusses arguments by proponents and opponents of DCCs, DSAs, and credit insurance programs, as well. Part II of the article, which will appear in the Fourth Quarter 2004 issue of *Compliance Corner*, will examine consumer protections and will contain an appendix of sample disclosure forms provided by the OCC that a bank may use.

Introduction

DCCs and DSAs are two consumer products that industry analysts and observers believe will be increasingly offered by credit card issuers, due in large part to the release of regulation (12 CFR 37) by the Office of the Comptroller of the Currency (OCC). Previous OCC guidance related to debt cancellation contracts has been replaced by this regulation, which provides a framework for DCCs and DSAs offered by national banks.[1] The regulation, which became effective June 16, 2003, addresses concerns over consumer protection, insurance licensing, risk management, standardization, and supervisory authority.

In general, banks have responded favorably to the new regulation, indicating a growing interest in offering DCC and DSA products to their customers as an alternative to traditional credit insurance products. According to Beth L. Climo of the American Bankers Insurance Association (ABIA), "The key to the new regulation is that it clearly articulates and resolves the fact that debt cancellation and suspension contracts are banking products. This should be a real positive for the products. It gives banks a standard that can be imposed nationally, as opposed to credit insurance that is regulated on a state-by-state basis."[2] The OCC recognized the future potntial of banks switching from conventional credit insurance toward more flexible debt protection products. In a September 2002 press release, a spokesperson for the federal regulator stated, "We expect that a growing number of banks will begin offering these products because the OCC has clarified the regulation in a manner that strikes an appropriate balance between consumer protection and product design."[3] CardWeb.com, an independent publisher of payment card industry news, noted, "The popularity of these so-called debt cancellation contracts and debt suspension agreements among national bank credit card issuers has been substantial enough to prompt the recent OCC action which also adds some consumer protections."[4]

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[1] The final rule is available on the OCC's web site at <www.occ.treas.gov/ftp/release/2002-73.pdf>.

[2] Garver, Rob, "OCC Clears Way for Banks to Offer Debt Insurance," *American Banker*, September 18, 2002.

[3] See OCC Bulletin 2002-40, *Final Rule on Debt Cancellation Contracts and Debt Suspension Agreements*, September 24, 2002, at <www.occ.treas.gov/ftp/bulletin/2002-40.doc>.

[4] See *Credit Protection*, September 20, 2002, at <www.cardweb.com/cardtrak/news/2002/september/20a.html>.

As part of a request for public comment on "clear and conspicuous disclosures," issued in December 2003, the Board of Governors of the Federal Reserve System, recognizing an interest in DCCs and DSAs, requested comment on proposed amendments to Regulation Z specific to such products. Since that time, the Board has withdrawn its request for comment and decided not pursue a uniform standard for "clear and conspicuous" disclosures. Nevertheless, any state member bank that currently issues or is considering the issuance of DCCs or DSAs should contact its supervisory Federal Reserve Bank for appropriate guidance.

New Regulatory Definitions

As part of the new regulations, definitions of DCCs and DSAs were provided for banks and their customers. A ***DCC*** is defined as a loan term or a contractual arrangement modifying loan terms linked to a bank's extension of credit, under which the bank agrees to cancel all or part of a customer's obligation to repay an extension of credit from that bank upon the occurrence of a specified event. The regulation does not define what is meant by a "specified event," giving national banks leverage to design their own products to include death, disability, and/or involuntary unemployment. A ***DSA*** is the counterpart to a DCC, defined by the OCC as a loan term or a contractual arrangement modifying loan terms linked to a bank's extension of credit, under which the bank agrees to suspend all or part of a customer's obligation to repay an extension of credit from that bank upon the occurrence of a specified event. In this case, specified events can include permanent disability, unemployment, or unexpected illness. Both products require that the customer pay an additional fee, either in a lump sum payable at the outset of a loan or on a monthly basis, to the bank in exchange for the bank's promise to cancel or suspend the borrower's obligation to repay the loan. Both contracts may be part of a loan agreement or contained in a separate document.

Credit insurance, such as credit life and disability, customarily involves the issuance of a group insurance policy to the customer's bank. Under a credit insurance contract, the bank enrolls customers, who pay an insurance premium for coverage defined in a certificate of insurance. In the event of the customer's death or disability, the affiliated third-party provider, not the credit card issuing bank, pays the benefits and assumes any risk connected with the policy. The key distinction to note between credit insurance and DSAs is that there is actually a payment made on the account with credit insurance, thereby bringing down the balance while the consumer is sick or unemployed. DSAs suspend the payments due on the account.

Background

DCCs have been sold to customers for nearly forty years. In fact, national banks were first authorized to offer DCCs by the OCC in 1963. At that time, the OCC concluded that offering DCCs was a lawful exercise of the powers of national banks in connection with the business of banking. In 1964, Comptroller James J. Saxon recognized DCCs as legitimate banking products when he stated:

Any state member bank that currently issues or is considering the issuance of DCCs or DSAs should contact its supervisory Federal Reserve Bank for appropriate guidance.

"The ability of national banks to offer DCCs is not a means for national banks to invade the field of insurance. Rather, it is recognition by the OCC of a national bank's right to protect itself by the establishment and maintenance of appropriate reserves against anticipated losses in connection with its lending activities. The necessity to maintain such reserves and to adjust its charges in relation to both reserves and the risk involved in a particular transaction has long been recognized as an essential part of the business of banking."[5]

In August 1971, the OCC clarified its earlier ruling concerning DCCs by stating that a national bank may offer

[5] Statement From James J. Saxon of the Office of the Comptroller of the Currency on Debt Cancellation Contracts and their Relation to State Law, May 18, 1964.

to cancel the outstanding loan balance upon the death of the borrower. Moreover, an Interpretative Letter (12 CFR 7.7495 (1972)) allowed banks to establish necessary reserves to cover possible losses associated with these products. Between 1972 and 1984, the OCC released two additional Interpretive Letters, which further refined its position concerning debt cancellation products. In 1972, the OCC permitted national banks to offer DCCs to compensate for loss of collateral. Early in 1984, Interpretive Letter No. 283 was released, which stated that national banks could sell credit life and disability insurance as an "incidental power" and that selling such insurance was directly related to a bank's expressed lending authority.

Over twenty years after first being authorized by the OCC, the Eighth Circuit Court of Appeals upheld the federal regulator's view that such products were banking products and not the business of insurance. Not long after this appellate court decision, the OCC responded to mounting requests from senior banking industry executives to facilitate business line diversification by amending regulations covering DCCs to include disability of a borrower. In 1998, the OCC acted again by permitting national banks to offer their customers debt suspension agreements as part of their express authority to make loans. The following year, Congress passed the *Gramm-Leach-Bliley Act* (GLBA), which allowed companies with varying business lines to offer a greater assortment of products to their customers. The new law removed the remaining restrictions on combining banking, securities, and insurance activities under the auspices of a single financial company. More importantly, the new law promoted greater financial integration and reaffirmed the authority of national banks and their subsidiaries to sell insurance.

Common Features and Requirements

Although many variations of credit protection products currently exist, there are certain uniform features and requirements of these programs. Common features of DCC and DSA programs include the following:

- Proof of employment history 60 to 90 days prior to the policy activation date and a minimum of 30 hours full-time work per week.
- An age eligibility requirement. Regulation B (*Equal Credit Opportunity Act*) prohibits lenders from discriminating against credit applicants provided they have the ability to contract. It is unclear at this time if the age requirements now employed by issuers violate this federal requirement.
- The customer's right to cancel the policy at any time at no charge.
- Credit protection limits between $10,000 and $15,000.
- Program fees that are automatically deducted from the customer's existing bank account or automatically added to their credit card account balance.
- Premiums that vary between 69 cents and 89 cents per $100 of outstanding balance.
- No fees when a credit card balance is not carried for a given month.
- The inability to use a credit card account for cash advances, transactions, balance transfers, or wire transfers after a cancellation or suspension period commences.
- Finance charges that do not accrue during the deferral period.
- Coverage periods that generally range from six months to one year for debt suspension agreements.
- Activation periods that vary, but usually the consumer must be participating in program for a minimum of 30 days.

Arguments Related to DCC, DSA, and Credit Insurance Programs

Consumer advocates have questioned the ultimate usefulness of credit insurance products for consumers. Reservations expressed concerning these products include the following:

- The programs tend to be expensive—the minimum monthly premium could exceed the minimum monthly payment without insurance.
- If a cardholder does not carry a monthly balance, the product's economic practicality may be questionable.
- In case of death, basic term life insurance may be a less expensive alternative and, in some states, balances may be forgiven.
- Often, issuers will work with accountholders to establish a payment plan in the absence of a credit protection product in the event of unemployment or disability.
- The benefits to the consumer may be minimal, since these products have an extremely low loss ratio—the proportion of a total premium returned to a consumer who suffers an insured loss—of generally between 30 and 40 percent. The National Association of Insurance Commissioners recommends a minimum loss ratio of 60 percent.

The Consumer Federation of America (CFA), a leading consumer advocacy group, has stated that in spite of the potentially greater flexibility of DCCs and DSAs, they view both products as the same as credit insurance and equally unnecessary. Bob Hunter, the CFA's insurance director, told the *American Banker*, "Debt cancellation products and credit insurance are technically the same thing—it's like butter and margarine. But most consumers have no need to buy either."[6] Some observers have argued that the DSA product in particular is an even less desirable consumer product than credit insurance, since payments on an account are only temporarily suspended and outstanding balances remain at their pre-suspension levels.

Conversely, a number of industry observers and regulators believe DCC and DSA products can provide a consumer with financial security and peace of mind. In general, advocates believe that debt cancellation contracts and debt suspension agreements satisfy a distinct customer need by providing support in times of financial difficulty and protection against damage of credit ratings, among other benefits. A recent study conducted by Thomas A. Durkin of the Federal Reserve Board's Division of Research and Statistics, *Consumers and Credit Disclosures: Credit Cards and Credit Insurance*, suggests that consumers may realize positive benefits from the purchase of credit protection products. In the study, Durkin notes, "Others see the product as safeguarding not creditors, but rather uninsured individuals and their families who could otherwise face financial uncertainty and distress from an unpaid debt in the event of an uninsured personal disaster."[7] The Durkin study also provides data suggesting that consumers have a positive view toward credit insurance products offered to installment credit customers. "In 2001, more than 90 percent of installment credit users with credit insurance indicated a favorable attitude toward the insurance. The product is good, or good with some qualification, and about nineteen in twenty purchasers of credit insurance on installment credit in 2001 said that they would purchase it again."[8]

The Durkin study also provides data suggesting that consumers have a positive view toward credit insurance products offered to installment credit customers.

Final Thoughts

Many credit card issuers currently offer or have considered offering DCC and DSA products to enhance product diversity and thereby enhance profitability. Comments provided by industry observers and banking regulators portend increased sales of DCCs and DSAs. In this context, standards established by the OCC regarding the purchase and sale of DCCs and DSAs will benefit credit card issuers searching for product diversification. The OCC regulation also clearly defines DCCs and DSAs as national banking products, not insurance products, essentially ending the debate regarding state regulatory authority and supervision.

Part II of the article, which will appear in the Fourth Quarter 2004 issue of *Compliance Corner*, will discuss consumer protections specific to DCCs and DSAs. In the interim, if you have any questions about this article or DCCs or DSAs in general, please contact Supervising Examiner Robert W. Snarr, Jr. (robert.snarr@phil.frb.org) through the Regulations Assistance line at (215) 574-6568 or Staff and Career Development Coordinator Frederick W. Stakelbeck (frederick.w.stakelbeck@phil.frb.org) at (215) 574-6422.

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[6] American Financial Services Association, *Debt Cancellation Product Poised for Takeoff*, December 1, 2001, at <www.spotlightonfinance.org/issues/December01/stories/story7.htm>

[7] Durkin, Thomas, "Consumers and Credit Disclosures: Credit Cards and Credit Insurance," *Federal Reserve Bulletin*, April 2002, at <www.federalreserve.gov/pubs/bulletin/2002/0402lead.pdf>.

[8] Ibid.

The ABCs of PMI

by Cynthia L. Course, CPA, Senior Financial Specialist

The *Homeowners Protection Act of 1998* (HPA), also known as the "PMI Cancellation Act," addresses homeowners' difficulties in canceling private mortgage insurance (PMI) coverage.[1] HPA became effective on July 29, 1999 and applies primarily to mortgage loan transactions consummated on or after that date to finance the acquisition, initial construction, or refinancing of a single-family dwelling that serves as a borrower's principal residence.

About PMI

PMI facilitates lending at affordable rates to borrowers who cannot, or choose not to, provide adequate down payment by protecting lenders from the risk of default and foreclosure. It is generally used when the loan to value (LTV) ratio of a residential mortgage transaction would exceed 80 percent at settlement. As loan principal payments are made, the LTV ratio of a loan that was above 80 percent at settlement will generally decline, creating the opportunity for the cancellation or termination of the insurance. HPA protects homeowners by prohibiting life-of-loan PMI coverage when the borrower pays the PMI premium and establishes uniform procedures for cancellation and termination of PMI policies.

[1] The full text of the *Homeowners Protection Act of 1998* is available on the GPO's web site at <frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=105_cong_public_laws&docid=f:publ216.105.pdf>.

Borrower Paid vs. Lender Paid PMI

There are two types of PMI—Borrower Paid PMI (BPMI) and Lender Paid PMI (LPMI). With BPMI, as the name suggests, the borrower pays the PMI premium and the interest rate on the loan is generally the market level rate for similar quality loans. With LPMI, the payments are made by a person or organization other than the borrower and the interest rate on the loan is generally higher than that on a similar quality loan with BPMI.

BPMI can be terminated at the borrower's request or under other conditions, as discussed below. However, LPMI is terminated only when the mortgage is refinanced, paid off, or otherwise terminated.

Cancellation and Termination – Non High-Risk Mortgages

Borrower Paid PMI on non high-risk mortgages can be cancelled or terminated in three ways: borrower request, automatic termination, or final termination.[2] A **borrower can initiate PMI cancellation** by submitting a written request to the servicer. Upon receiving the request, the servicer must take action to cancel PMI when the principal balance of the loan reaches or is first scheduled to reach 80 percent of the original value, provided that the borrower also has a good payment history, is current on payments, and satisfies any requirement of the mortgage holder for (i) evidence that the value of the property has not declined below the original value and/or (ii) certification that the borrower's equity in the property is not subject to a subordinate lien.

[2] See the *Homeowners Protection Act of 1998* for special provisions related to high-risk mortgages.

A servicer is required to **automatically terminate PMI**, even without a request from the borrower, on the date that the principal balance of the mortgage is first scheduled to reach 78 percent of the original value of the property, provided that the borrower is current on payments. If the borrower is not current on that date, then PMI must be terminated on the first day of the first month following the date that the borrower becomes current.

If PMI was not canceled at the borrower's request or by the automatic termination provision, the **final termination** provisions apply. Under these provisions, the servicer must terminate PMI coverage by the first day of the month immediately following the date that is the midpoint of the loan's amortization period if, on that date, the borrower is current on payments. If the borrower is not current on that date, PMI should be terminated when the borrower does become current.

Disclosures

The Act requires the lender to provide disclosures at consummation that describe the borrower's rights for PMI cancellation and termination. Initial disclosures vary, based upon whether the transaction is at a fixed or adjustable rate, involves borrower paid or lender paid PMI, or is a high-risk loan. The borrower must also be provided with certain annual and other notices concerning PMI cancellation and termination.

For additional information on each of the ABCs of PMI, and for information beyond the ABCs, please refer to the text of the legislation. If you have specific questions on the requirements of HPA or their application to your institution, please contact your primary regulator. If you are supervised by the Federal Reserve Bank of Philadelphia, please contact Supervising Examiner Robert Snarr (robert.snarr@phil.frb.org) or Supervising Examiner John Fields (john.d.fields@phil.frb.org) through the Regulations Assistance Line at (215) 574-6568.

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