



August 24, 2021

Commissioner of Financial Protection and Innovation
Attn: Sandra Sandoval, Regulations Coordinator
300 South Spring Street, 15th Floor
Los Angeles, CA 90013

Via: regulations@dfpi.ca.gov

Re: Notice of Second Modifications to Proposed Regulations Under Division 9.5 of the California Financial Code PRO 01/18

To Whom It May Concern:

Financial Innovation Now (“FIN”)¹ appreciates the opportunity to provide input on the Department of Financial Protection and Innovation’s (DFPI) notice of second modifications to proposed regulations (the Proposed Regulations) under Division 9.5 of the California Financial Code.

FIN supports measures to help recipients better understand the terms of their commercial financing arrangements and comparison shop between products. We thank the DFPI for its tireless efforts on the implementation of Sections 22800–22805 of the California Financial Code and to give providers of commercial financing products certainty with respect to the content, timing, and format of required disclosures

FIN therefore appreciates the DFPI’s efforts throughout this rulemaking process. We are writing this letter to address a single unintended consequence of the way the Proposed Regulations’ rules regarding the annual percentage rate (APR) calculation for open-end credit products. The Proposed Regulations’ rules regarding the APR calculation for open-end credit products require providers to mix *rates* and *fees*. Rates are interest rates applied to periodic balances. Fees are transaction-based and other fees, the sum of which may depend on how a borrower uses a product. This approach creates significant challenges for clear and meaningful disclosure of the cost of credit.

Regulation Z, implementing the Truth in Lending Act, used to require disclosures for open-end credit products that similarly mixed rates and fees. After years of research, the Federal Reserve found that these disclosures were largely unintelligible to consumers, and in 2008, it modified the requirements for open-end credit products to eliminate these disclosures. FIN recommends that the DFPI follow Regulation Z’s approach in its Proposed Regulations. Regulation Z requires providers to disclose rates in the form of an APR and fees in plain language. This approach is easy to understand. Annualization of transaction-based fees while assuming specific borrower behavior, on the other hand, can lead to APR disclosures that bear no relation to the true cost of credit and can make comparison-shopping a bewildering experience.

¹ FIN is an alliance of leading innovators—Amazon, Apple, Google, Intuit, PayPal, Square and Stripe—working to modernize the way consumers and businesses manage money and conduct commerce. For more information regarding FIN’s policy priorities and principles, please visit <https://financialinnovationnow.org>.

The Proposed Regulations take on the challenging task of applying concepts developed for consumer financing products to a novel context. The situation addressed by this letter, however, is one where the DFPI can benefit from the multi-decade evolution of Regulation Z since the Truth in Lending Act was passed in 1968. California businesses deserve the same clear and intelligible disclosures that consumers receive pursuant to Regulation Z.

I. FIN Supports Clear and Conspicuous Disclosure of All Finance Charges

FIN supports the clear and conspicuous disclosure of all finance charges, and therefore supports the DFPI's cross-reference to 12 C.F.R. Part 1026.4 to incorporate Regulation Z's definition of finance charge into the Proposed Regulations.

One of the objectives of Regulation Z's broad definition of finance charge was to prevent creditors from evading disclosure requirements by hiding the cost of credit in fees that may be less visible to a borrower. FIN believes that this broad definition of finance charge is appropriate and necessary for borrowers to understand the cost of credit and engage in comparison shopping. Moreover, FIN believe that this definition of finance charge is appropriate for the required disclosures of finance charges for open-end credit products.²

II. Including All Finance Charges in the APR Calculation for Open-End Credit Products Will Generate Significant Borrower Confusion

The Proposed Regulations require that providers include all finance charges in the APR calculation for open-end credit products, which creates significant challenges for clear and meaningful disclosure of the cost of credit and can make products that are similar in total program cost appear to be dramatically more or less expensive than one another.

Section 2062(4) requires providers to disclose the APR cost of open-end credit products, calculated in accordance with Section 3001. Section 3001(a) provides that the APR is "a measure of the cost of credit, expressed as a yearly rate, that relates the amount and timing of value received by the recipient to the amount and timing of payments made to the provider" and that "[f]or purposes of this subchapter, the annual percentage rate shall be determined in accordance with either the United States Rule method or the actuarial method, as both are set forth in Appendix J, 12 C.F.R. Part 1026." Section 3001(d) also provides the APR calculation should "include all finance charges as defined in Section 3010" and that "[w]hen calculating the required disclosures for the commercial open-ended credit plans made pursuant to Section 2062, the provider shall assume that the recipient borrows the approved credit limit at origination and makes no subsequent draws and that minimum on-time payments are made pursuant to the contract." All finance charges as defined in Section 3010 include all finance charges as defined in 12 C.F.R. Part 1026.4, as described above in Section II.

This calculation method has the potential to result in confusing APR disclosures that obscure the true cost of credit for various open-end credit products that exist in the market today. Take, for example, an open-end credit product for which there are no interest charges applied to periodic balances. Users are

² Specifically, Section 2062(5) requires financiers to disclose the total finance charge calculated in accordance with Section 3010. Under Sec. 3010, the "finance charge" is the sum of "all charges that would be included in the finance charge under 12 C.F.R. part 1026.4 (effective April 1, 2019), if the transaction were a consumer credit transaction and the financier were a creditor under federal law." 12 C.F.R. Part 1026.4 defines "finance charge" to include a wide variety of charges that may be assessed in connection with a credit transaction, including interest and transaction charges.

simply charged: (a) a card creation fee to generate a card to begin drawing on a credit line; (b) transaction-based fees amount to 0.2% of each transaction plus a 20 cent fixed fee for each transaction; and (c) foreign exchange fees if the transaction involves a currency conversion. The Proposed Regulations would require a provider to assume that the borrower draws the entire approved credit limit at origination, so a provider would be required to sum all finance charges that would be assessed on a single transaction the size of the entire approved credit limit. This approach generates a few complications.

First, the Proposed Regulations do not provide guidance to providers on which finance charges to include in this calculation where a borrower's choices determine which fees will be assessed. For example, if a provider charges foreign exchange fees, it is not clear whether or not a provider may assume that the initial draw at origination does not involve a currency conversion.

Second, the annualization of transaction-based fees can make open-end credit products with shorter settlement cycles appear dramatically more expensive than similarly priced products with longer settlement cycles. For example, assuming that a borrower has a \$1000 approved credit limit and that a provider need not consider card creation or foreign exchange fees in its APR calculation, for a single \$1000 draw, the provider in our example would charge 0.2% of \$1000 plus 20 cents, or \$2.20. Application of Section 3001 to satisfy the requirement of Section 2062(4) would yield APRs that wildly vary depending on how frequently borrowers must settle with the issuing bank:

- *Scenario 1—Monthly Settlement:* With monthly settlement, the APR is roughly equal to $(0.0022 / 30) * 365 * 100 = \mathbf{2.7\%}$
- *Scenario 2—Weekly Settlement:* With weekly settlement, the APR is roughly equal to $(0.0022 / 7) * 365 * 100 = \mathbf{11.5\%}$
- *Scenario 3—Daily Settlement:* With daily settlement, the APR is roughly equal to $0.0022 / 1) * 365 * 100 = \mathbf{80.3\%}$

This variation occurs despite the fact that the borrower pays exactly \$2.20 for every \$1000 they draw:

- If the borrower in Scenario 3 were drawing \$33.33 in a single transaction each day for 30 days, their total fees on \$1,000 of borrowing would amount to \$2.20, yielding a fee ratio of **0.22%**.
- If the borrower in Scenario 2 were drawing \$250 in a single transaction each week for 4 weeks, their total fees on \$1000 of borrowing would amount to \$2.20, yielding a fee ratio of **0.22%**.
- If the borrower in Scenario 1 were drawing \$1000 in a single transaction each month, their total fees on \$1,000 of borrowing would amount to \$2.20, yielding a fee ratio **0.22%**.

Even though the fee ratio is identical in each scenario, the Proposed Regulations' prescribed method for APR calculation makes the daily settlement structure scenario appear to be dramatically expensive.

III. Regulation Z Takes a Different Approach for Open-End Credit Plans

The bizarre result created by Proposed Regulations' current approach is the result of the mixing of rates and fees in the APR calculation for open-end credit products. Regulation Z takes a different

approach and treats APR disclosure and transaction-based fee disclosure for open-end credit products separately.

At account opening, providers must disclose the APR, defined as “[e]ach periodic rate that may be used to compute the finance charge on an outstanding balance... expressed as an annual percentage rate.”³ Separately, providers must disclose “[a]ny non-periodic fee that relates to opening the plan,”⁴ “[a]ny fixed finance charge and a brief description of the charge,”⁵ and “[a]ny transaction charge imposed by the creditor for use of the open-end plan for purchases.”⁶

Model Form G-17(B) illustrating what Regulation Z requires is included in Appendix G to Regulation Z. This model form clearly delineates between disclosure of interest-related charges, which includes APR disclosure, and disclosure of other fees, including transaction-based fees, one-time fees, or fees that depend on borrower behavior.⁷ See Appendix for Model Form G-17(B).

IV. The Federal Reserve Conducted Extensive Consumer Research to Address a Similar Issue in Regulation Z

Model Form G-17(B) was introduced into Regulation Z by the Board of Governors of the Federal Reserve System (the **Federal Reserve**) in a 2008 rulemaking amending Regulation Z.⁸ Prior to that 2008 rulemaking, Regulation Z required providers to disclose an “effective APR” in periodic statements following account opening. This effective APR reflected both the cost of interest and certain other finance charges imposed during the statement period, effectively mixing rates and fees in an APR calculation.

The Federal Reserve conducted extensive consumer testing of this concept⁹ and ultimately determined in that 2008 rulemaking that this method for APR calculation and disclosure generated so much consumer confusion that it was at odds with the purpose of Regulation Z. As a result, it eliminated the effective APR requirement entirely when it finalized its 2008 amendments. At that time, the Federal Reserve wrote that although “a majority of participants evidence some understanding of the effective APR, the overall results of the testing show that most consumers do not correctly understand the effective APR.... [I]n all rounds of the testing, *a majority of participants did not offer a correct explanation of the effective APR*. In quantitative testing conducted for the [Federal Reserve] in the fall of 2008, *only 7% of consumers answered a question correctly that was designed to test their understanding of the effective APR*. In addition, *including the effective APR on the statement had an adverse effect on some consumers’ ability to identify the interest rate applicable to the account*.”¹⁰

V. The DFPI Should Adopt Regulation Z’s Approach

³ 12 C.F.R. Part 1026.6(b)(2)(i).

⁴ 12 C.F.R. Part 1026.6(b)(2)(ii)(B).

⁵ 12 C.F.R. Part 1026.6(b)(2)(iii).

⁶ 12 C.F.R. Part 1026.6(b)(2)(iv).

⁷ 12 C.F.R. part 1026, Appendix G, G-17(B).

⁸ See Federal Reserve, [Truth in Lending](#), 74 Fed. Reg. 5244, at 5432.

⁹ See 74 Fed. Reg., at 5317-18. The Federal Reserve conducted at least *four* rounds of qualitative and quantitative testing, once in 2007 and three times in 2008.

¹⁰ 74 Fed. Reg., at 5252 (emphasis added). See also 74 Fed. Reg. 5316 – 5319 for more discussion.

Including all finance charges in the resulting APR calculation, including transaction-based fees as well as one-time upfront fees (e.g., card creation fees), has the potential to result in confusing APR disclosures by mixing rates and fees, particularly for open-end credit products that charge no interest. A prospective effective APR for an open-end credit product that mixes rates and fees is likely to be even more confusing than an ex post effective APR, like the one that the Federal Reserve rejected in 2008.

To implement Regulation Z's approach, the DFPI should make the following revisions to the Proposed Regulations:

- *Section 3001*: Insert a new phrase following Section 3001(b), so that it reads:

“(b) The annual percentage rate calculation shall include all finance charges as that term is defined in section 3010 of these rules, except that when calculating the required disclosures for commercial open-ended credit plans made pursuant to Section 2062, the provider may include only those finance charges that would be included in the annual percentage rate calculation for open-end (not home-secured) plans under 12 C.F.R. Part 1026.6(b)(2)(i).”
- *Section 2062(5)*: Insert a new subsection (iii) following Section 2062(5)(C)(ii) that reads:

“(iii) If the contract provides for finance charges that are transaction-based fees, one-time fees, or contingent fees, a sentence stating ‘You may be charged finance charges that are not included in your APR,’ followed by a plain language description of each potential fee.”
- *Section 2062(4)*: Insert a new subsection (iv) following Section 2062(4)(C)(iv) that reads:

“(iv) If the contract does not provide for an interest rate, ‘APR is the cost of your financing expressed as a yearly rate. APR includes the amount of the funding you receive, interest and certain other fees you pay and the payments you make. APR is not an interest rate. Your interest rate is 0%.’”

Following each subsection (i) through (iv), insert:

“You may be assessed finance charges that are transaction-based fees, one-time fees, or contingent fees that are not reflected in your APR. These finance charges are described below in the row labelled ‘Estimated Finance Charge’.”

We urge the DFPI to hew more closely to Regulation Z's approach and more clearly delineate finance charges that should be clearly disclosed to borrowers and finance charges that should be included in APR calculations. In the alternative, a novel prospective effective APR requirement that departs from well-researched and well-established practice under Regulation Z should be carefully considered to determine whether it will enhance borrower understanding.

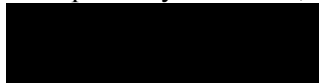
VI. The DFPI Should also Create a Pathway for Financiers to Seek Approval of Alternative Disclosure Formats

The Proposed Regulations take on the task of applying concepts developed for consumer financing products to a novel context. From time to time, innovative products may appear that have features not clearly contemplated by the disclosure categories and requirements set forth in Sections 2061 – 2068. To ensure that it can remain nimble and react to market developments, DFPI should include in the

final regulations a mechanism by which providers can apply to the DFPI to vary the prescribed disclosures, seek exemptive relief, or seek approval of alternative disclosure formats.

FIN appreciates the opportunity to comment on the DFPI's proposed regulation and looks forward to continuing our joint efforts to help ensure meaningful and helpful financing disclosures.

Respectfully submitted,



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VII. Appendix

G-17(B) Account-Opening Sample

Interest Rates and Interest Charges	
Annual Percentage Rate (APR) for Purchases	8.99% This APR will vary with the market based on the Prime Rate.
APR for Balance Transfers	15.99% This APR will vary with the market based on the Prime Rate.
APR for Cash Advances	21.99% This APR will vary with the market based on the Prime Rate.
Penalty APR and When it Applies	28.99% This APR may be applied to your account if you: <ol style="list-style-type: none"> 1) Make a late payment; 2) Go over your credit limit twice in a six-month period; 3) Make a payment that is returned; or 4) Do any of the above on another account that you have with us. <p>How Long Will the Penalty APR Apply?: If your APRs are increased for any of these reasons, the Penalty APR will apply until you make six consecutive minimum payments when due.</p>
Paying Interest	Your due date is at least 25 days after the close of each billing cycle. We will not charge you any interest on purchases if you pay your entire balance by the due date each month. We will begin charging interest on cash advances and balance transfers on the transaction date.
Minimum Interest Charge	If you are charged interest, the charge will be no less than \$1.50.
For Credit Card Tips from the Consumer Financial Protection Bureau	To learn more about factors to consider when applying for or using a credit card, visit the website of the Consumer Financial Protection Bureau at http://www.consumerfinance.gov/learnmore

Fees	
Annual Fee	None
Transaction Fees	
• Balance Transfer	Either \$5 or 3% of the amount of each transfer, whichever is greater (maximum fee: \$100).
• Cash Advance	Either \$5 or 3% of the amount of each cash advance, whichever is greater.
• Foreign Transaction	2% of each transaction in U.S. dollars.
Penalty Fees	
• Late Payment	Up to \$35 .
• Over-the-Credit Limit	Up to \$35 .
• Returned Payment	Up to \$35 .
Other Fees	
• Required Account Protector Plan	\$0.79 per \$100 of balance at the end of each statement period. See back for details.

How We Will Calculate Your Balance: We use a method called "average daily balance (including new purchases)." See your account agreement for more details.

Billing Rights: Information on your rights to dispute transactions and how to exercise those rights is provided in your account agreement.