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ADVISORY RULING #75
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Re: Annual Charges on Lender Credit Cards

Several questions from creditors have been received by the Bureau concerning the implementation of an amendment to the Code that permits the assessment of annual fees for the use of lender credit cards. The new law, P.L. 1983, c. 384, which will become effective January 1, 1984, amends § 2-501(1) by adding a new paragraph E, which reads as follows:

[Creditors may receive the following additional charges:]

E. An annual charge, not to exceed \$12 on each account, for the privilege of using a lender credit card. A charge assessed pursuant to this paragraph may be assessed only on the renewal date of the lender credit card or on the anniversary thereof. No charge may be assessed pursuant to this paragraph before January 1, 1984.

Copies of the original draft of this Advisory Ruling were circulated for comment to those creditors that had posed questions to the Bureau, as well as to representatives of industry trade associations and consumer groups.

The questions and issues raised will be addressed through the following question and answer format.

1. IS THE ANNUAL FEE A PROSPECTIVE OR RETROSPECTIVE CHARGE?

This is a threshold question which has a direct bearing on some, if not most, of the actions a card issuer must take to impose the fee.

The fee is a prospective charge. It may be imposed to compensate the card issuer for the expenses that it will incur in extending to the cardholder the privilege of using a credit card. The fact that the fee is prospective is derived from the language of the first sentence of paragraph E. That sentence allows the card issuer to impose the annual charge on the cardholder for the privilege extended to him of "using a lender credit card." The verb "use" appears in its gerund form "using" which connotes the continuation of a current activity into the future. Were the fee to be applied retrospectively, the Legislature would have used a past tense of the verb such as "...for the privilege

of having used a lender credit card." Moreover, imposing the fee retrospectively would be unfair to existing cardholders. If the fee was retrospective, a cardholder whose card was issued in January, 1983 could be assessed \$12 in January, 1984 when the card was renewed for the privilege of having used the card for the preceding 12-month period. Such a constitution of the statute is unfair and unreasonable for it would condone and permit the assessment of a fee for use during a period of time when such fees were expressly prohibited. By treating the fee as prospective, all existing cardholders are forewarned that if they want to continue their relationship with the card issuer it will be at a cost.

Nevertheless, some commentators have drawn attention to the differences in language between L.D. 1179 - the original bill proposing a credit card fee - and L.D. 1577 - the bill that was finally enacted - in support of the argument that the fee is retrospective. Specifically, they point to the repeal of the words "payable in advance" in L.D. 1179 as evidence of the Legislature's intent to make the fee retrospective. Further, they argue that a prospective interpretation of the statute will result in the loss of the fee for the first year of a newly-issued credit card - a result that is contrary to the basic thrust of legislative intent which is to allow collection of the fee as of January 1, 1984.

The proposed repeal of the words "payable in advance" in L.D. 1179 is not persuasive evidence of legislative intent in L.D. 1577, simply because the formulas used by the two bills for imposing the fee differ. In L.D. 1179, a credit against the annual fee was to be made based on the cardholder's accumulated finance charges during the preceding year. As a practical matter, it appeared much easier under that scheme to not assess the annual fee until the finance charge credit was determined - which would be at the end of the year - rather than to impose the fee in advance and make retroactive adjustments to it. Because L.D. 1577 did not use that formula - in fact, it even amended a different part of the statute - the proposed elimination of those words in L.D. 1179 cannot be considered persuasive evidence as to the intent of the Legislature in this latter L.D.

The second argument supporting a retrospective approach to the fee - the avoidance of the incongruous result of giving away one "free" year's worth of use when the statute was expressly enacted to stop free use - is similarly unpersuasive. The fact that there is a potential for free use of a credit card under this statute is not the result of treating the fee as either prospective or retrospective - it stems from a flaw in the statute itself. Even under a retrospective view of the fee, a "street-wise" consumer could always terminate his relationship with the card issuer just prior to the renewal or anniversary date of his card and thereby avoid the fee. No matter which approach one takes, there is room for mischief under the present wording of the statute. Had the statute permitted the fee to be imposed on "the date of issuance and annually thereafter," this problem could have been avoided. If that represents what the Legislature meant, the Legislature will have to amend the statute: it is not within the power of an administrative agency to do so.

In summation, the annual fee is a prospective charge designed to compensate the card issuer for present and future use of the card.

2. MAY AN ANNUAL FEE BE IMPOSED ON A NEWLY-ISSUED CARD?

No. Paragraph E clearly states that the charge may be assessed "only on the renewal date of the lender credit card on the anniversary thereof." Thus, a card originally issued after January 1, 1984 may not have a charge imposed on it until its first renewal date. Because the fee is prospective, the charge will be for the coming year's use of the card.

3. MAY AN ANNUAL FEE BE IMPOSED ON CARDS IN EXISTENCE PRIOR TO JANUARY 1, 1984 THAT RENEW OR HAVE RENEWAL ANNIVERSARIES AFTER THAT DATE?

Yes. Credit cards in existence on January 1, 1984 that will renew or will have anniversaries of renewal in or after 1984 may have annual fees assessed on them on those occasions. As already mentioned, the fee is prospective and will cover the use of the card during the coming year.

4. MUST THE CHANGE IN TERMS NOTICE REQUIRED BY § 3-204 OF THE CODE BE GIVEN TO EXISTING CARDHOLDERS BEFORE THE ANNUAL FEE IS IMPOSED?

Yes. The mere fact that an annual fee may be imposed on lender credit cards after January 1, 1984 does not alter the fact that the fee represents an optional change by the card issuer in the agreement it has with its open-end credit customers. As such, the change must be preceded by the required notice, i.e., by at least 30-days' notice before the card's renewal date or renewal anniversary date, since these dates are the only times when the fee can be assessed.

5. IF A CREDIT CARD IS NOT RENEWED AT RENEWAL TIME, BUT A BALANCE IS MAINTAINED BY THE FORMER CARDHOLDER, MAY THE ANNUAL FEE STILL BE ASSESSED?

No. Paragraph E permits the assessment of an annual fee for the privilege of using a lender credit card. Where the cardholder voluntarily terminates use of the card not only has he foregone the "privilege" of using the card but, as a practical matter, he has also lessened the card issuer's potential for incurring non-compensable expense. A major rationale for allowing an annual fee on lender credit cards was that certain sections of the Code, notably §§ 2-202(5) and 2-402(4) which establish a 25-day grace period on the imposition of finance charges on consumer loans and credit sales, allowed cardholders to pay off their credit card balances before incurring a finance charge. Such a practice permitted cardholders to use the card issuer's funds at no cost to themselves. The annual fee assured the card issuer that it would receive some compensation for its services, especially in those cases where the cardholders paid off his balance within the grace period and avoided a finance charge. With the card not being available for the incurring of further debt, the logic for the fee disappears. Moreover, the balance on the open-end credit account carried forward by the cardholder is still subject to a finance charge.

The negative answer to this question is also compelled by § 3-204 of the Code which deals with changes in terms of open-end credit accounts. Subsection 2 of that section states that when a creditor changes the terms of an open-end account, the consumer may elect to continue that portion of the account in existence prior to the date of the change at the old rate. Thus, if upon being notified by a card issuer that an annual fee is to be imposed on his credit card, the cardholder decides to avoid the extra charge, he may elect under §3-204(2) to forego the privilege of using the card but still maintain the existing balance without the imposition of the annual fee.

6. WHEN MAY THE ANNUAL FEE BE IMPOSED ON CARDS ISSUED FOR PERIODS LONGER THAN ONE YEAR?

Answer to this question requires an understanding of the concept of the term "renewal" in § 2-501(1)(E), for it is only on renewal, or the anniversary of renewal that the annual fee may be

imposed. The Code does not define the term "renewal," thereby compelling an examination of other sources to discern its meaning. One obvious source is Regulation Z, and the Official Staff Commentary to Regulation Z. While the term is not expressly defined in the Regulation, it is described in the Commentary (at § 226.12(a)(2)) as generally contemplating "the regular replacement of existing cards because of, for example, security reasons or new technology or systems." (Emphasis added.) While the Bureau is not compelled to adopt this "definition" in interpreting the Code, the definition does offer a useful guide as to one form of renewal: the regular physical replacement of cards. This cannot be the full scope of the definition, however. An examination of the real-world context in which the term is used in § 2-501(1)(E) reveals that greater flexibility is needed in defining renewal.

The Legislature was aware that credit cards were issued for various durations, primarily twelve, eighteen, twenty-four and thirty months. Some card issuers have adopted these longer issuance periods to lessen overhead costs. In the face of this knowledge, the Legislature prohibited the imposition of fees until the "renewal date of the credit card or the anniversary thereof." If renewal was tied strictly to the re-issuance of the plastic cards, some card issuers would be penalized by their efforts to lessen overhead since they would be prohibited from imposing the fee for, in the worst case, two and one-half years after the date of original issuance. This is not a rational result, particularly in light of the statute's permitting an annual fee to be imposed.

Further, lender credit card agreements expressly recognize that the card issuer is not obligated to make advances at any particular point. The agreement is terminable at will by either party and generally is renewed by card replacement. While physical replacement of the card generally constitutes contractual renewal of the agreement, physical replacement of the card is not a prerequisite to contractual renewal. An express agreement by the card issuer and cardholder that the contract renews annually after the date of original issuance is just as much a renewal as the date when a piece of plastic is replaced. Consequently, there are at least two events that may constitute "renewal": (1) the date of regular physical replacement of the card by the card issuer, and (2) the date specified in the contractual agreement of the parties which is not less than one year after the date of original issuance, and each year thereafter. The card issuer would have the choice as to which of these two alternatives it wanted to pursue in structuring its credit card program. If the date of card replacement is chosen as the renewal date, once the card is replaced each following year will be either an anniversary of renewal or a new renewal. (See question 7 for a discussion of how this approach applies to cards issued for periods other than multiples of one year (e.g., eighteen or thirty months).) If the annual "contractual" renewal concept is chosen the first year following the original date of issuance, and each year thereafter will be a new renewal of the contract. This latter alternative accommodates card issuers that replace cards en masse at a particular time of year without necessarily having regard to when cards were previously issued.

If the card issuer chooses to use the "card replacement" approach as the basis for identifying "renewal," any wholesale shift by the issuer to advance the date when newly-issued cards would be replaced, and thereby renewed, so that the annual fee could be imposed sooner than would otherwise be the case, would be regarded as circumvention or evasion of the Code by the Bureau.

7. IF A CREDIT CARD IS RENEWED FOR MORE THAN A ONE-YEAR PERIOD, MAY A CARD ISSUER CHARGE MORE THAN THE \$12 FEE TO COVER THE FULL LENGTH OF THE ISSUANCE PERIOD? FOR EXAMPLE, MAY A CARD ISSUER REPLACING A CARD FOR AN 18-MONTH DURATION CHARGE AN \$18 FEE?

No. The fee is limited to \$12 annually and can only be assessed at the time of renewal or on the anniversary of renewal. In light of the answer to question 6, however, the fee will always be capable of collection even if the duration of the card's issuance is for longer than 12 months and the issuance period is not a multiple of one year. In such a case, the fee will simply be collected in increments. An example, assuming use of the maximum \$12 fee, will help to explain the operation of the statute in this situation. A card is originally issued in June, 1984 for replacement (renewal) in April, 1985. At that point, the card will be re-issued for eighteen months, the card issuer's normal cycle. A \$12 fee may be imposed in April, 1985 for the coming year. In April, 1986 another fee may be imposed, for this date represents an anniversary of renewal. However, because the card was issued for eighteen months, it is due for replacement (renewal) in October, 1986, only six months hence. Because the agreement's duration at this point is limited to six months, only a \$6 fee may be imposed at this time. If the card is renewed in October, 1986 for another eighteen months, a \$12 fee may be imposed at this time for the period ending October, 1987. At this point, the cycle repeats itself.

8. IF AN ACCOUNT IS CLOSED BY THE CARDHOLDER PRIOR TO THE TIME WHEN IT WOULD NORMALLY END, DOES THE CARD ISSUER HAVE TO REBATE A PRO RATA PORTION OF THE ANNUAL FEE?

No. Under §2-501 of the Code and §226.4(c)(4) of Regulation Z, membership fees are expressly excluded from the finance charge and as such are not subject to the rules on rebate under §2-501. Consequently, card issuers are under no legal obligation to refund portions of an annual fee that are not fully "earned."

9. MAY THE ANNUAL FEE BE COLLECTED IN INCREMENTS?

Yes. Paragraph E specifies that the charge (1) is an annual charge, and (2) may only be assessed on the renewal date or anniversary thereof, but it is silent as to how the fee may be collected. While assessment is to be made at a specific time, there is nothing preventing a card issuer and a cardholder agreeing, by contract, that the fee is to be paid incrementally.

10. IF MORE THAN ONE CARD IS ISSUED TO AN ACCOUNT, MAY EACH CARD BE SUBJECT TO THE ANNUAL FEE?

No. The fee may only be assessed against the single account.

While disclosure of the annual charge is not an issue under §2-501(1)(E), it is worth remembering that Regulation Z requires disclosure. Section 226.6(b) of Regulation Z requires that "other charges" (of which the annual fee is one) must be disclosed in the initial disclosures accompanying the establishment of the open-end agreement. Further, § 226.7(h) requires that "other charges" be identified by type and disclosed if debited during the billing cycle. Thus, if an

account is debited for the annual fee, that billing cycle's statement must disclose the charge, identifying it as "annual fee," "service charge," et cetera.

/s/ Robert A. Burgess
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