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FEATURE ARTICLE

TILA "Finance" and "Other" Charges in Open-End Credit:

The Cost-of-Credit Principle Applied to Charges for Optional Products or Services

By Ralph J. Rohner* and Thomas A. Durkin**

I. Introduction

Thirty-five years after the enactment of the federal Truth in Lending Act ("TILA"),[1] the determination of its core computational and disclosure element, the "finance charge"—"the dollar amount the credit will cost you"[2]—remains challenging and elusive. In recent years the question has arisen several times: how should the law[3]

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[1] Truth in Lending Act (TILA) §§ 101-171, 15 U.S.C. §§ 1601-1666 (2004).

[2] This descriptive statement must accompany the disclosure of the finance charge amount in closed-end credit transactions. Regulation Z, 12 C.F.R. § 226.18(d). There is no comparable statement required for open-end credit.

[3] The "law" refers to TILA as the statutory source, but also includes several

characterize charges for products or services offered in connection with a credit transaction or open-end credit plan where those products or services are optional add-ons that the consumer may freely take or reject? The black-letter text of the statute is inconclusive, perhaps even Delphic.[4] So is the principal interpretive source, the Federal Reserve Board's ("FRB") Regulation Z.[5] Scholarly literature addressing "optional" charges as such is almost nonexistent.[6] Other interpretive guidance from the courts and from the FRB staff has been sporadic and uncertain, lacking any consistent benchmark on whether and when the cost of an optional product or service is a finance charge.[7] The uncertainty is compounded in open-end credit where finance charge items imposed during a billing cycle must not

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layers of regulatory amplification. TILA is implemented primarily through the FRB's Regulation Z, 12 C.F.R. part 226 (2004) [references hereafter to "Regulation Z § ___" are to the corresponding section in 12 C.F.R. part 226].

Regulation Z is further elaborated in the FRB Regulation Z Official Staff Commentary, a compilation of FRB staff interpretations of the regulation which appears separately in 12 C.F.R. part 226, Supplement 1 (2004) [references hereafter to this Commentary will use the style "Commentary ¶ ___" corresponding to the numbered paragraphs in Supplement 1].

When changes to Regulation Z or the Commentary are proposed or promulgated, the FRB publishes unofficial explanatory material about those changes in the Federal Register. This regulatory history material is hereafter referred to as "Supplementary Information," with references to pages in the Federal Register.

[4] "[T]he amount of the finance charge [is] determined as the sum of all charges, payable directly or indirectly by the person to whom the credit is extended, and imposed directly or indirectly by the creditor as an incident to the extension of credit." TILA § 106(a), 15 U.S.C. § 1605(a).

[5] Regulation Z § 226.4.

[6] *See generally*, RALPH J. ROHNER & FRED H. MILLER, TRUTH IN LENDING ch. 3 (2000); NATIONAL CONSUMER LAW CENTER, TRUTH IN LENDING ch. 3 (4th ed. 1999 & Supp. 2002); MARY DEE PRIDGEN, CONSUMER CREDIT AND THE LAW chs. 6, 8 (2003). Nor is there explicit discussion of charges for optional products in the leading early analysis of TILA finance charges. *See* Jonathan Landers, *Determining the Finance Charge Under the Truth in Lending Act*, 1 AM. B. FOUND. RES. J. 45 (1977).

[7] *See infra* notes 115-21 (discussing the FRB staff's treatment of expedited payment charges). Although the Board staff had informally opined that a creditor's fee for arranging expedited payment on a credit card customer's account was a finance charge, in this most recent instance of Commentary amendments they formally proposed that it be treated as an "other charge." The final version of the rulemaking found, instead, that it was *neither* a finance charge *nor* an "other charge," and fell outside the TILA disclosure rules altogether.

only be disclosed as such,[8] but must also be calculated into a historical annual percentage rate ("APR") for that cycle,[9] and where a separate category of consumer outlays that are not finance charges must be disclosed as "other charges."[10] In all of this, the stakes are high because mis-disclosure subjects the creditor to agency sanctions and liability for actual and statutory damages, including aggregates of those damages in class actions.[11]

Activity in the marketplace suggests that the offering of optional products and services is becoming a more common technique for creditors to expand their customer services, compete for market share, and increase revenues from their consumer credit portfolios. These offerings are part of a larger trend toward the "unbundling" of costs and fee structures.[12] Some contemporary examples include charges for: debt cancellation agreements, or "gap" coverage;[13] expedited delivery of credit cards;[14] arranging expedited payments, routinely or to avoid a late charge;[15] assigning a mortgage

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[8] Regulation Z §§ 226.6(a), 226.7(f).

[9] *Id.* at §§ 226.7(g), 226.14(c).

[10] *Id.* at § 226.7(h).

[11] Truth in Lending Act (TILA) § 130, 15 U.S.C. § 1640 (2004).

[12] Mitchell Pacelle, *Growing Profit Source for Banks: Fees From Riskiest Card Holders*, WALL ST. J., July 6, 2004, at A1. Many creditors, especially in credit card plans, are aggressively imposing new and higher charges for consumers who technically default (as by making late payments or exceeding a credit limit), or whose overall risk profile increases (based on credit bureau data). *Id.* These kinds of price adjustments have been criticized for imposing higher credit costs on poorer consumers who are financially more risk-prone. *Id.*

[13] After a rulemaking proceeding in 1995-96, certain of these charges are now addressed explicitly in Regulation Z §§ 226.4(b)(10), 226.4(d)(3). They *are* finance charges unless expressly disclosed as optional and separately authorized by the consumer in the same manner as credit insurance. There have been recent press reports about the popularity and profitability of variants of these debt cancellation or debt suspension agreements, and a preliminary inquiry about them by the FRB. See discussion *infra* notes 131-36.

[14] In 2003, the FRB staff declared that these fees are neither finance charges nor "other charges." Commentary ¶¶ 6(b)-2.ix, 6(b)-2.x.

[15] The 2003 Commentary revision states that such a customer charge, incurred occasionally to avoid late payment or cure a delinquency in an open-end credit plan is neither a finance charge nor an other charge. Commentary ¶ 6(b)-2.x. But the interpretation does not apply to "expedited" payment arrangements agreed to when the plan is first established. 68 Fed. Reg. at 16,185, 16,186 (Apr. 3, 2003).

in connection with a refinancing;[16] subordination agreements;[17] and providing copies of transaction documents.[18]

Especially for open-end credit plans, one can envision an additional array of optional services that a creditor might offer for a fee which the customer might choose to acquire, such as: use of a customer hotline; generating an annual compilation of credit purchases; sending paper periodic statements, instead of "free" electronic statements (or vice versa); providing new checks to draw on a credit line; optional property insurance; or a "premium" cardholder upgrade (with frequent-flyer or other travel perks). The list of possibilities is as long as the marketing ingenuity of the credit industry is fertile. There is some guidance on how to treat certain examples of optional charges, but the process involves assessing each charge on an ad hoc basis, either by the FRB staff or in the courts. The generic question remains: whether these charges are "imposed . . . incident to the extension of credit."[19]

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[16] This type of charge was recently the subject of litigation in the federal appellate court in New York. *See* Pechinski v. Astoria Fed. Sav. & Loan Ass'n, 345 F.3d 78, 80-82 (2d Cir. 2003). A consumer refinancing a mortgage loan asked the original creditor to assign its mortgage to the refinancing creditor, thereby avoiding certain state and local taxes. The original creditor charged an "assignment fee." The court held that the fee was neither a finance charge nor a prepayment penalty: the fee was not a finance charge because it was not "incident to" an extension of credit, but rather to the extinguishment of a debt; it was not a prepayment penalty because that relates only to forfeited amounts of finance charge.

[17] For example, assume a consumer has a first (purchase-money) mortgage and a secondary (subordinate) home-equity line of credit ("HELOC") outstanding on his home. When the consumer refinances the first mortgage, the HELOC creditor may charge a fee to accept and continue its subordinate priority position. Although the fee may be "required" by both creditors, it is optional in the sense that the consumer could theoretically pay off the HELOC creditor and remove the subordination issue. *Query*: If this subordination fee is considered a finance charge, for which creditor is it such—the lender refinancing the first mortgage loan (who requires and benefits from the subordination), or the HELOC lender who actually receives the fee?

[18] Such fees charged to open-end account holders are apparently not finance charges under the current Commentary. A fee for copies of transaction documents is listed as an "other charge" (not a finance charge) if the request is submitted as a billing error under Regulation Z § 226.13(a)(6). Commentary ¶¶ 6(b)-1.ii, 13(a)(6)-1. But if a consumer requests transaction documents *"for income tax purposes,"* the fee that the creditor charges is excluded from the "other charge" category and so is nothing for TILA purposes. Commentary ¶ 6(b)-2. There is no explicit mention of document requests for other than tax purposes, such as for bookkeeping or account reconciliation. This seems curious regulatory line-drawing!

[19] Regulation Z § 226.4(a).

The thesis of this article is that a more workable approach to characterizing fees for optional products and services is possible by focusing on charges that represent payment for discrete products or services of value to the consumer, freely chosen by consumers as contract options which do not affect the amount of credit available to the consumer, the consumer's access to it, or the allocation of payment responsibility and credit risk in the transaction or plan. In other words, these fees are for separate—or separable—purchases, analogous to subsequent events in closed-end credit that require no new disclosure or adjustment in the disclosed finance charge.[20] The primary focus of this article is on open-end credit because it involves greater interpretive and operational challenges.

This article first explains, in Part II, the critical role of "finance charges" and "other charges" as costs imposed in credit transactions and thus elements in the TILA disclosure scheme. Part III provides a broad overview of the marketing and economic considerations that influence how creditors price their products, concluding that there is a long-accepted economic framework for identifying the true costs of credit. The next section, Part IV, analyzes the existing legal guidance on whether and when charges for optional products or services are finance charges or "other charges" in the TILA regime, suggesting that the current law lacks a consistent and coherent principle. Parts V and VI then propose a set of extreme alternative approaches, and several intermediate approaches on how TILA might deal with optional charges, and analyze how those approaches lack economic integrity. Finally, Part VII suggests a different approach that builds on accepted economic premises and characterizes charges as finance charges only when they compensate the creditor for one of the four recognized components of the cost of credit—origination, servicing, funding, and risk. Recognition of this principle, the authors suggest, can be accomplished, without amendments to TILA or Regulation Z, by amendments to the Official Staff Commentary.

II. The Setting: The Role of "Finance Charge" and "Other Charge" Characterizations in the TILA Disclosure Scheme

Before analyzing the special problems posed by charges for optional products and services, it is necessary to review briefly the

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[20] *Id.* § 226.17(e).

role that finance charges—and "other charges"—play within the TILA structure.

A. Finance Charge as an Essential Disclosure and Calculation Component

1. Disclosure of Finance Charges as Dollar Amounts

For all consumer credit transactions, TILA requires creditors to calculate and disclose the dollar amount of charges that are within the regulatory definition of finance charge.[21] For closed-end credit, the amount of the finance charge must be emphasized within the "federal box" of segregated disclosures.[22] For open-end credit plans, creditors must initially disclose the manner of determining finance charges that may be imposed from time to time,[23] and must also disclose on the periodic statement the dollar amounts of those charges imposed during the billing cycle.[24] Thus, accurate identification of charges as finance charges, or not, is critical to comply with fundamental TILA disclosure requirements.

2. Identifying Finance Charge Amounts Necessary to Determine the Disclosed APR

The finance charge not only represents the cost of the credit as a dollar amount, but is an essential element in determining the APR, which is the universal, comparative unit-cost descriptor for consumer credit.

a. Closed-End Credit

For closed-end credit, the APR is derived from the payment schedule. The APR represents the annualized simple interest rate at which the scheduled payments amortize the amount financed over the

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[21] Regulation Z § 226.4.

[22] *Id.* § 226.17(a)(1).

[23] *Id.* § 226.6(a). Required disclosures made even earlier, in conjunction with credit and charge card applications and solicitations, also must disclose information about rates, fees, grace periods, and other cost components. *Id.* § 226.5a(b)(3).

[24] Regulation Z § 226.7(f).

fixed term of the transaction.[25] The role of the finance charge in this calculation is critical but indirect, in the sense that any amount that is a finance charge must be differentiated from the amount financed so that the derived APR accounts properly for all finance charge elements in the amortization.[26]

b. Prospective Disclosure in Open-End Credit

In open-end credit plans, the initial disclosures must include the nominal APR that results from the annualization of a periodic rate applied to outstanding periodic balances[27]—the classic 18% annual rate based on a monthly rate of 1.5% interest or service charges.[28] Specific fees that are finance charges—such as three dollars for a credit card cash advance—must be included in the account-opening disclosures,[29] and must also be disclosed as finance charges on the periodic statement for the cycle in which the charge was imposed.[30] If it is not possible to disclose finance charges in advance, such as the finance charge that arises from application of a periodic rate to a balance that is unknown when disclosures must be made, then the method of calculation must be disclosed.[31] Though disclosed, finance charges other than those arising from application of the periodic rate do not factor into a prospective APR in open-end credit.

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[25] *See id.* § 226.22, and Regulation Z Appendix J. Mathematically the APR is the periodic discount rate times the number of "unit periods" in a year that equates the stream of payments to its present value, the amount financed.

[26] For example, points or loan origination fees that are paid in cash or financed as part of the loan must be deducted from the nominal loan principal to reach the amount financed, the present value of the net credit extended. Regulation Z § 226.18(b) (defining amount financed). Indeed, *all* finance charges are excluded from the amount financed. Commentary ¶ 18(b)(3)-1.

[27] Regulation Z § 226.6(a)(2) (defining the corresponding annual percentage rate).

[28] Most open-end creditors now use daily, rather than monthly, periodic rates. For an eighteen percent annual percentage rate, the daily periodic rate is 0.00049315 (0.18/365).

[29] Regulation Z § 226.6(a)(4).

[30] *Id.* § 226.7(f).

[31] *Id.* § 226.6(a)(4).

c. The Special Case of Historical APRs in Open-End Credit

Since it is never known whether the consumer will incur a specific finance charge fee in a subsequent cycle, it is impossible to disclose prospectively a "blended" APR, i.e., one that combines the periodic rate on unpaid balances with specific dollar amounts for discrete activities (such as obtaining a cash advance). From the origins of TILA, however, the law has required that open-end creditors disclose a "historical" APR that totals all finance charges imposed during a cycle, relates that sum to the outstanding balance during that cycle, and annualizes the resulting rate.[32] For example, assume a consumer has a $1,000 average balance in the period, which accrues a fifteen-dollar finance charge by application of the periodic monthly rate of 1.5%. Further assume that the consumer also incurs a three-dollar cash-advance fee during that cycle. There is thus a total of eighteen dollars in finance charges for that month, or an annualized historical APR of 21.6%.[33]

This historical APR is accurate as far as it goes; consumers may understand that the cash advance fee pushed the effective credit cost upward last month, and so maybe they should be more cautious about using the cash advance feature in the future. But it is a dubious disclosure benefit at best. For one thing, the requirement that periodic finance charges be translated into an APR based on the balance outstanding in the same cycle in which the charge was incurred is altogether artificial and unrealistic. It assumes the consumer repays the cash advance, and the fee, within that same month, or at least before the due date for the consumer's payment for that period. A more accurate—real—APR would reflect the consumer's actual repayment pattern over succeeding months, but of course it is impossible for the creditor to know, at the time of sending the periodic statement, what that pattern will be.

Second, the amount of the historical APR is purely fortuitous. In the example above, if the consumer had obtained two cash advances in the relevant period, the disclosed APR would become 25.2%.[34] If the consumer had only a $100 balance (instead of $1,000),

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[32] Regulation Z §§ 226.14(c), 226.7(g) (containing the formula for calculating the historical APR).

[33] (18/1000) x 12 = 21.6 percent.

[34] The finance charge is now $15.00+$3.00+$3.00, or $21.00. Thus, (21/1000) x 12 = 25.2%.

the historical APR with one cash advance fee would be 54%; with two cash advance fees, it would be an even more startling 90% APR! Third, whether consumer behavior is influenced by the historical APR disclosure has no empirical confirmation. The consumer's decision to incur the cash advance fees was certainly not affected by this disclosure that took place well after those transactions, possibly by as much as a month. In short, the value of periodic aggregation and disclosure of finance charge fees, and computation of them into an historical APR, is considerably attenuated. But it is the law.

3. Post-Contract Changes in Terms

There is another way in which the characterization of a fee as a finance charge affects the TILA disclosures: when the creditor changes the terms of the account. In closed-end credit this is rarely an issue, as the price terms of the transaction are generally fixed at the outset and rarely change thereafter, and in any case, disclosure is only required once, at the point of consummation of the transaction.[35] If a closed-end creditor were to impose a new charge at a later time,[36] no new disclosure would be required on account of that "subsequent event"—unless the "subsequent event" is a refinancing, which is a new extension of credit requiring new disclosures.[37] But for open-end credit, a creditor's ability to change terms to reflect risk or increase revenue is a linchpin of the open-end product line. Virtually all open-end plans include provisions allowing the creditor to change terms at will; the consumer is deemed to have accepted the new terms by continuing to use the credit line. As a matter of contract law, courts have recognized that open-end credit is essentially a continuing offer which the creditor may modify or withdraw.[38] Usually, by state law[39]

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[35] Regulation Z § 226.17(b).

[36] A possible example could be a requirement for private mortgage insurance if the value of the mortgaged property declined below a certain debt to value ratio.

[37] Regulation Z § 226.17(e).

[38] *See* Garber v. Harris Trust & Sav. Bank, 432 N.E.2d 1309, 1312 (Ill. App. Ct. 1982) (discussing a classic holding on this point); *see also* Mandel v. Household Bank (Nevada), 129 Cal. Rptr. 2d 380, 383-84 (Cal. Ct. App. 2003) (providing a more recent example of a holding on this point). In other recent litigation, some creditors have been exposed to liability for violations of TILA and state consumer fraud laws for marketing credit cards with apparently fixed price terms, such as "no annual fee," but then changing those terms within a short time. Rossman v. Fleet Bank, 280 F.3d 384, 400 (3d Cir. 2002); Roberts v. Fleet Bank, 342 F.3d 260, 268-69 (3d Cir. 2003).

and widespread industry practice, a consumer who objects to the changed term may pay off the account balance on its original terms but cannot make new draws on the credit line.

TILA generally requires specific advance disclosure to consumers of changes in the terms of open-end plans.[40] This applies to any of the types of charges that must be disclosed when the account is solicited or opened, and therefore includes any finance charge elements. A credit card issuer who wants to increase the periodic rate, for example, or increase the amount of cash advance fees—both clearly involving changes in the amounts of finance charge imposed—must send written notice of the change to all affected card holders at least fifteen days before the effective date of the change. This means that a creditor faces a significant logistical chore in preparing and mailing change-in-terms notices in proper form, either along with periodic statements or by separate mailing, to its entire portfolio of card holders, or at least all of them subject to the changed term. Whether or not a particular newly imposed charge is a finance charge therefore affects the creditor's disclosure responsibilities regarding changes in terms, and the timing of the effective date of the changed term.

B. Relationship of Finance Charges to "Other Charges" in Open-End Credit

Even if charges for optional products or services are not finance charges, they may have to be disclosed as "other charges" in open-end credit plans. Since their enactment in 1968, TILA and Regulation Z have required that open-end creditors describe in the initial disclosures "other charges which may be imposed as part of the plan."[41] Regulation Z also requires that each periodic statement itemize the amounts and types of "other charges" imposed during the

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[39] *See, e.g.*, UNIF. CONSUMER CREDIT CODE § 3.205 (1974) (typifying state laws requiring notice before changes in terms).

[40] Regulation Z § 226.9(c)(1). Subsection (2) of the same section excuses creditors from having to send change-in-terms notices in several circumstances: where the change involves late or over-limit charges, documentary evidence fees, suspension or termination of the account, or changes resulting from judicial proceedings or the consumer's default. *Id.* § 226.9(c)(2). Interestingly, these exceptions include any reduction of any component of a finance charge or other charge; no advance information about good-news changes, only bad.

[41] Truth in Lending Act (TILA) § 130, 15 U.S.C. § 1637(a)(5) (2004); Regulation Z § 226.6(b).

period.[42] Thus, if one option is to treat charges for optional products or services as finance charges, another option is to treat them as "other charges." Because closed-end credit has no comparable "other charge" category, the discussion here is applicable only to open-end plans.

Legislative and regulatory history gives little guidance as to what constitute "other charges." They are obviously not finance charges.[43] By general comparison to the rules for closed-end credit, "other charges" could include various late, delinquency, or default charges.[44] Or, read literally, they could include any conceivable charge that might ever be levied under the plan, regardless of amount or contingency.

The FRB Staff Commentary refers to "other charges" as "significant charges related to the plan,"[45] suggesting that fees which are not significant in amount (or recurrence?), or fees not related to the plan, are not "other charges." "Significant" compared to what? Does "related to the plan" mean that "other charges" must be part of the contractual plan, or may they be extrinsic to it?

The Commentary lists seven examples of "other charges."[46]

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[42] Regulation Z § 226.7(h).

[43] *Id.* The line between finance charges and other charges can itself be the subject of dispute—all the way to the Supreme Court. In Pfennig v. Household Credit Serv., Inc., 295 F.3d 522 (6th Cir. 2002), the Court of Appeals accepted plaintiff's argument that certain over-limit charges meet the literal definition of finance charge even though the Commentary to Regulation Z puts them in the "other charge" category. Commentary ¶6(b)-1.i. The Supreme Court reversed, holding that the FRB Commentary characterization was not unreasonable and therefore controlled. Household Credit Serv., Inc. v. Pfennig, 124 S. Ct. 1741, 1749-50 (2004).

[44] For closed-end credit, the only specific "charges" (other than finance charges) that must be disclosed are late payment and security interest charges. Regulation Z § 226.18 (l), (o).

[45] Commentary ¶6(b)-1.

[46] *Id.* The seven examples of "other charges" are:

1. Late payment and over-the-credit-limit charges;

2. Fees for providing documentary evidence of transactions [requested under the provision on Billing Error Resolution];

3. Charges imposed in connection with real estate transactions such as title, appraisal and credit report fees;

4. A tax imposed on the credit transaction by a state or other governmental body;

With the possible exception of example (2)—fees for providing documentary evidence of transactions—each of these examples assumes the charge is required to establish, maintain in good standing, or terminate the credit plan. None of these examples describe charges for truly optional products or services. There is little guidance from this eclectic list on whether various unmentioned charges for optional customer services should be considered "other charges."

If a charge for optional services or products is not a finance charge but is an "other charge," the charge must be included in the initial disclosure when the account is opened, and must be reflected on the periodic statement for any cycle in which the charge is levied. Also, like a finance charge, the introduction of a new "other charge," or a change to an existing one, requires an advance change-in-terms notice in most cases. For creditors wishing to offer, for a fee, optional customer services that may be only infrequently used, the change-in-terms notice requirement may be a real hang up. It would require that creditors send notices to perhaps thousands or millions of customers to flag a possible fee that few of them would ever incur. Periodic adjustments to a roster of incidental service fees could burden the periodic statement process, and prevent creditors from using the extra envelope space for other products or marketing promotions.[47]

C. The Wild-Card Category: "Not 'Other Charges'"

If the choices for characterizing charges for optional customer products or services were limited to "finance charge" or "other charge," the differences would be modest. As discussed, both sets of charges must be disclosed to consumers when opening an account and on periodic statements. If a creditor changes any of these charges, or introduces new ones, the creditor would usually need to

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> 5. A membership or participation fee for a package of services that includes an open-end credit feature, unless the fee is required whether or not the open-end feature is included;
>
> 6. [Certain] automated teller machine (ATM) charges;
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> 7. Charges imposed for the termination of the open-end credit plan.

Id.

[47] Even without TILA requirements, creditors wishing to change contract terms for existing card holders presumably would need to communicate the changes to effect contractual agreements with those customers. TILA adds explicit format and timing requirements and the threat of liability for misdisclosure. Regulation Z § 226.9(c); TILA § 130, 15 U.S.C. § 1640 (2004).

give change-in-terms notices. The only significant difference is that "other charges" would not be factored into the historical APR.

On the other hand, if optional customer service fees are neither finance charges nor "other charges," they apparently drop off the TILA radar screen, and consumers have no legal right to any particular form of disclosure about them. Is this possible?

It is indeed possible that certain customer charges related to a credit account or plan disappear completely from the TILA landscape. In closed-end credit, this appears partly by inference—the required TILA disclosures do not address a number of post-consummation events or services that may trigger customer fees, such as default and foreclosure charges, or charges for deferrals or extensions—and partly by cross-reference, i.e., the TILA closed-end disclosures must refer the consumer to the credit contract for further information. For open-end credit, the Commentary carves out a subset of examples of charges that are "exclusions" from the "other charge" category. [48] In other words they are "not 'other charges,'" and require no disclosure at all. This is a curious catalog of examples. Several refer to charges that already must be disclosed under other parts of Regulation Z.[49] One item deals with default-related charges

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[48] Commentary ¶ 6(b)-2 provides:

> The following are examples of charges that are not "other charges":
>
> i. Fees charged for documentary evidence of transactions for income tax purposes;
>
> ii. Amounts payable by a consumer for collection activity after default; attorney's fees . . .; foreclosure costs; post-judgment interest rates . . . ; and reinstatement or reissuance fees;
>
> iii. Premiums for voluntary credit life or disability insurance, or for property insurance, that are not part of the finance charge;
>
> iv. Application fees . . . ;
>
> v. A monthly service charge for a checking account with overdraft protection that is applied to all checking accounts, whether or not a credit feature is attached;
>
> vi. Charges for submitting a check that is later returned unpaid;
>
> vii. Charges imposed on a cardholder by an institution other than the card issuer for the use of the other institution's ATM . . . ;
>
> viii. Taxes and filing or notary fees . . . ;
>
> ix. A fee to expedite delivery of a credit card . . . ;
>
> A fee charged for arranging a single [expedited] payment on the credit account . . . .

Id.

[49] *E.g.*, taxes, filing or notary fees are on the "not 'other charges'" list, but those charges are excluded from the finance charge only if "itemized and

that TILA has generally left to the parties' contract.[50] Another item—application fees—relates to charges required of unsuccessful as well as successful applicants, and so is disconnected from the credit eventually granted. Another—ATM fees—refers to third-party charges. Yet another—checking account service charges—rests on the premise that the charge is not a function of an extension of credit. Until 2003, only one item on the list—fees for documentary evidence for tax purposes—appeared to cover an optional service to the consumer. The two newest additions, items (ix) and (x), added in 2003, also recognize that certain "optional" customer service charges fall altogether outside the TILA disclosure rules. It is hard to see a principled common denominator to this "not 'other charges'" category, except perhaps expediency; it probably represents an ad hoc process of regulatory accretion over time, answering one interpretational question at a time. Note also that the list is by way of examples, suggesting that there may be other fees or charges—perhaps not yet invented—that also fit this third category.

In reality, the debate over the proper treatment of fees for optional products or services is between "finance" and "other" charges on the one hand, either of which characterization entails substantial disclosure responsibilities, and "not 'other charges'" on the other hand, which carry no TILA responsibilities at all. As the credit industry unbundles, and proliferates, its pricing components and charges for various products, it is attractive to the industry to keep as many components as possible off the TILA chessboard. Consumerists and other observers, in turn, worry that the fragmentation of pricing components into non-finance charge categories threatens the basic integrity of the TILA disclosure policy and its approach to "the cost of credit." It is disclosure of the cost of credit, after all, that underlies TILA in the first place.

III. Marketing, Economic and Policy Considerations

Aside from all the legalisms—and before returning to them in the next section—it is helpful to consider the competitive marketplace in which the legal issues arise. Consumer credit,

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disclosed." Regulation Z § 226.4(e). Likewise, premiums for credit or property insurance are "not 'other charges,'" but these also require specific disclosures to be excluded from the finance charge. *Id.* at § 226.4(d).

[50] Informally, the Federal Reserve staff had indicated that a "reissuance fee" under item (ii) could include a fee for issuing a new card to replace one that was lost or stolen. That kind of reissuance now seems explicitly covered by new item (ix).

especially open-end credit, is a popular product marketed by banks and other institutions intensely concerned about market share and profitability.[51] What are the influences that drive pricing strategies and produce the array of fees and charges that are the focus of this article?

A. Economic Influences; Maintaining Creditor Revenue Streams

1. Product Complexity

Much of the complexity of the legal concept of the finance charge arises because of two interrelated difficulties: (1) the necessity of trying to separate into components, and even subcomponents, transactions that by their nature are parts of a whole and not easily separable; and (2) the requirement for specific lengthy and detailed disclosures about the secondary components of the credit part, i.e. the amount financed, finance charges, and "other charges," with substantial penalties for mistakes. It is a brew destined for controversy at the least, with the potential to be frustrating and costly for those responsible for complying.

First, concerning separating transactions into components, it is worth remembering that consumers do not purchase credit services as ends in themselves, as they might do with football tickets or new suits of clothes. Rather, credit is normally a single part of a larger undertaking: it involves changing the pattern of payments for

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[51] According to FRB Statistical Release G.19 for July 8, 2004, consumer credit outstanding at the end of May, 2004 totaled $2.031 trillion of which $742 billion was revolving (open-end) credit, most of it credit-card credit, and $1.280 trillion was non revolving credit. Federal Reserve Statistical Release G.19, Consumer Credit (July 8, 2004) *at* http://www.federalreserve.gov/releases/G19/20040708/. In recent decades the volume of consumer credit outstanding relative to consumer sector disposable personal income (income after taxes, or "DPI") has fluctuated cyclically in a relatively narrow range and has not risen much overall. Within consumer credit outstanding, however, revolving credit has risen since the late 1960s relative to DPI, and non revolving credit has trended downward relative to DPI over the same period. These trends suggest that the technological changes that have permitted widespread production of revolving credit over this period, together with increasing popularity of its features among consumers, have led to a substitution of revolving for non revolving credit. *See* Thomas A. Durkin, *Credit Cards: Use and Consumer Attitudes 1970-2000*, FEDERAL RESERVE BULLETIN, Chart 1, at 624-25 (Sept. 2000) (illustrating the trends in consumer credit).

consumer purchases into a preferred timing scheme.[52] Thus, by its nature, credit use most often is only the time payment component of a purchase totality that also involves acquisition of something else. Residences, vehicles, other durable household goods, sizeable recreation items, college educations, vacations, holiday gifts, and even restaurant meals are examples of substantial purchases often directly associated with time payment—credit use.[53]

Second, besides a direct relation to specific goods or services purchased on credit, the totality of many credit events often includes the purchase of additional ancillary financial services such as insurance and even deposit accounts. Some kinds of insurance are very closely related to the credit product, for example, private mortgage insurance, which is insurance against default on the mortgage. Other kinds of insurance that might be purchased simultaneously are less closely related directly to the credit, such as homeowners' property insurance or automobile liability insurance. Such purchases often occur along with and as part of the totality of an event generating credit use, whether the underlying transaction involves direct purchase of goods and services or only a simple loan of money. Correctly differentiating the costs of the credit component from the rest of the transaction can be tricky enough in cases like insurance to require assumptions and rules of thumb. Even then, all the regulatory assumptions, rules of thumb, and compliance decisions made under them must pass muster under legislative and court-induced disclosure standards that themselves are not static.

Third, business firms, as profit-oriented enterprises, are naturally going to try to sell additional products and services whenever they sense an opportunity to do so at a price sufficiently above cost.[54] Any business firm selling goods or services to consumers is going to think about what else it can sell at the same

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[52] The basic theory of finance as dependent upon the timing of cash flows is found in any textbook in the field. *See, e.g.,* RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE, 4th ed., 15-23 (1991).

[53] In 1970, a survey of consumers, undertaken for the National Commission on Consumer Finance, found that few consumers considered the credit component to be a more complicated part of the purchase decision process for consumer durable goods than the choices associated with the durables themselves. To the best of our knowledge a similar survey has not been undertaken since then. *See* GEORGE S. DAY & WILLIAM K. BRANDT, A STUDY OF CONSUMER CREDIT DECISIONS, TECHNICAL STUDIES OF THE NATIONAL COMMISSION ON CONSUMER FIN., Vol. 1, No. 3, 42 (1973).

[54] *See generally* JOSEPH SCHUMPETER, CAPITALISM, SOCIALISM, AND DEMOCRACY (1942) (providing a classic discussion of entrepreneurial motivation).

time, even those selling time payments (credit) rather than other goods and services. This is hardly surprising behavior. The fact that a creditor also sells something else does not automatically make the other sale credit, however, or turn the cost of the other component automatically into a finance charge.

Fourth, even though it may be difficult to isolate the credit portion of a transaction in a way that makes credit disclosures easy, creditors will typically have to do even more than that. With modern technology and a competitive marketplace, creditors can no longer rely on cross subsidies among broad classes of credit products or groups of customers to guarantee overall institutional profitability. Such an approach would simplify disclosures to be sure, but marketplace conditions will no longer permit it. Rather, creditors are going to have to consider the price of a variety of product components and customer groups separately to avoid losing the customers who are eligible for the best deals. If this complicates the process of allocating the parts of the credit products into proper buckets for required disclosures, it is something they will need to live with. This development deserves a bit more discussion because it is part of the reason why financial transactions sometimes seem so complicated today.

2. Product Complexity and Disclosures

Congress rightly understood in 1968 that credit use typically was part of a larger transaction involving time payment for some purchases. It also understood that information available to consumers at that time about the pricing of credit was confusing to the point of being chaotic. Banks typically quoted rates on an annual discount basis but collected payments in monthly installments. Rate ceilings for banks under state laws were often stated in annual discount-rate form, but calculating finance charges this way resulted in an effective yield about twice the stated rate. Retail store creditors, a much more important group of consumer creditors in 1968 than today, typically quoted rates on an add-on basis consistent with their own rate ceilings found in state retail installment sales acts.[55] Effective yields

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[55] For discussion of rates and rate quotation before TILA, *see generally* ROBERT W. JOHNSON, METHODS OF STATING CONSUMER FINANCE CHARGES (1961); BARBARA A. CURRAN, TRENDS IN CONSUMER CREDIT LEGISLATION (1965); WALLACE P. MORS, CONSUMER CREDIT FINANCE CHARGES (1965); NATIONAL COMMISSION ON CONSUMER FINANCE, CONSUMER CREDIT IN THE UNITED STATES: THE REPORT OF THE NATIONAL COMMISSION ON CONSUMER FINANCE 169-71 (1972). After discussing conditions that existed before passage of

due to add-on rates were also about twice the rate employed in the calculation, but add-on rates are mathematically distinct from discount rates and behave quite differently as maturities lengthen, even for a given nominal rate. Consequently, add-on rates are not comparable to discount rates although they look similar superficially. Finance companies quoted either add-on rates or percent per month, depending on the nature of the underlying transaction and how it was regulated. Again this meant that their charges were not easily comparable with those of other institutions using different calculation methods. Credit unions also generally quoted percent per month, but in a form not readily comparable with the other institutions, including the finance companies who also quoted percent per month but whose state regulations often involved stepped rates with multiple levels.

In this environment, Congress passed the TILA in 1968 to improve disclosure of credit costs.[56] Although TILA, as amended over the years, contains some provisions regulating practices of creditors, mostly in the area of rescission rights on loans secured by residences, credit card solicitations, credit card billing, home equity lines of credit, and high-cost mortgages, the law always was and still remains primarily a disclosure statute. Furthermore, there is no doubt that Congress intended to require disclosure of credit costs, as complicated or as bound up with other things as that may be. This intent is revealed in many places in the hearing record and discussions of the time but probably no more clearly than in the introductory remarks of Senator William Proxmire, the chief sponsor of the bill that ultimately became TILA:

Truth in Lending, the National Commission on Consumer Finance in its 1972 Report made the following observation:

> As a result of these varying forms of quoting the rate of charge, consumers could often compare rates among lenders in one class, such as commercial banks, but seldom between classes of lenders, such as credit unions and commercial banks. Inter-industry rate comparisons would have been possible only if all segments of the industry used the same basis for disclosing finance rates, whether dollar add on, dollar discount, percent per month, or annual percent. But because different segments of the consumer credit industry were wedded to various methods of calculating and disclosing rates by historic precedent and, in many cases by state laws, comparison shopping for credit across industry lines was almost impossible. This lack of comparable rate disclosure helped create a climate favorable for legislation requiring uniform quoting of rates of charge.

NATIONAL COMMISSION ON CONSUMER FINANCE, *supra*, at 170.

[56] Truth in Lending Act of 1968, Pub. L. No. 90-321, tit. I, 82 Stat. 146 (1968) (codified as amended at 15 U.S.C. §§ 1601-66 (2004)).

> The first principle of the bill is to insure that the American consumer is given the whole truth about the price he is asked to pay for credit. The bill would aim at full disclosure of the cost of credit so that the consumer can make intelligent choices in the marketplace.
>
> The second principle is that the whole truth about the cost of credit really is not meaningfully available unless it is stated in terms that consumers in our society can understand. Without easy knowledge of this unit price for credit, it is virtually impossible for the ordinary person to shop for the best credit buy.
>
> A third principle is that the definition of finance charge, upon which an annual percentage rate is calculated, needs to be comprehensive and uniform. It needs to be uniform to permit a meaningful comparison between alternative sources of credit. The definition of finance charge also needs to be comprehensive in order to convey the true cost of credit.[57]

After Congress passed TILA, industry disclosure practices changed sharply and information about credit pricing became much more available and comparable, but disclosure legislation did not alter the increasing pace of change in financial markets that occurred in the following decades. There is much greater variety and complexity in the credit group of products available to consumers today than there was among their antecedents of thirty or forty years ago, yet it was familiarity with those relatively primitive products that produced TILA. Even the classic model of closed-end credit has evolved from a one shot transaction paid off in due course, to a variety of fixed-term, but adjustable, credit arrangements. Consumers may now purchase goods on credit, or lease them for a limited term.[58] Sometimes the credit obligation may include a balloon, or a surrender option that resembles a lease but really is not. Interest rates on

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[57] *Introductory Remarks to Accompany S.5*, CONG. REC. S1202 (Jan., 1967). The original sponsor of Truth in Lending was Senator Paul H. Douglas of Illinois, who was defeated for re-election in November, 1966. During the series of hearings on credit disclosures in the early 1960s, the proposed Truth in Lending Bill was typically referred to as the "Douglas Bill."

[58] As a practical matter, consumer leasing amounts to using credit but with an assumed residual value greater than zero at the end of the lease period.

everything from home mortgages to credit cards may be adjustable periodically to track an agreed index. There are wide differences in interest rates quoted to different consumers on the basis of risk. Reverse mortgages allow senior citizens to draw down the accumulated equity in their homes. Beyond all the contractual variations is the fact that closed-end credit obligations are frequently refinanced by consumers to take advantage of economic conditions or to address their own cash flow situations. Variations in types of replenishing open-end plans are even more dramatic.

3. Pricing Requirements

A requirement for disclosure of credit costs immediately begs the question: what are the costs that must be disclosed? As with any other goods or services, credit costs for consumers are the prices paid for the characteristics of credit use, i.e. deferred payment. Also, as with any other product or service, it is the specific characteristics of credit use that separate it from other things, for example, distinguishing credit use from other financial services like deposits or insurance. To see this point more clearly, it seems useful to recognize distinctions among products (or services) groups, different products/services groups, and differentiated products/services within groups.

In this context, a product or services group involves offerings with the same fundamental characteristics. An automobile, for example, has four wheels, a passenger compartment, and an engine of some sort that enables it to move independently of other vehicles. In contrast, a bicycle has two wheels and no means of self-locomotion, so it does not have the same characteristics as an automobile. In between, a motorcycle has some characteristics of each but is not the duplicate of either, and so it belongs to a third product group. Thus, although distinctions are not always perfectly clear, the basic idea is clear enough: products or services with the same basic characteristics belong to the same product/services group while offerings with different characteristics belong to different product/services groups.[59] Automobiles and television sets, for example, are very different products because they have very different characteristics, while automobiles and motorcycles are more closely related; nonetheless, they still are different products because they have different sets of

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[59] *See* KELVIN LANCASTER, VARIETY, EQUITY, AND EFFICIENCY 1-35 (1979) (providing a fuller, but accessible discussion of these points by the founder of characteristics theory in economics).

characteristics. Similarly, in the services area, haircuts are different services from college educations because they have different characteristics. Likewise, college educations are different from high school educations because their characteristics are different—or at least they should be.

Taking this distinction a step farther and looking in between different and the same products, differentiated products, or services are those that have the same characteristics but in different amounts. The education experience among colleges is differentiated by different amounts of academic rigor, party atmosphere, quality of facilities, nearness to a prospective student's home, and so forth. Likewise, as will be discussed further below, different sorts of credit, such as credit card accounts versus mortgage loans, all are part of the same product group because they have the same basic characteristics involving sorts of deferred payments. Nonetheless, they are not identical products because they have different amounts of the characteristics that constitute types of payment deferrals. In other words, they are differentiated products in this terminology. Because they have different amounts of vital credit characteristics, it should not be especially surprising that they typically sell for different prices.[60]

Economists recognize four fundamental components or basic characteristics of the deferred payment, or credit, service that creditors provide to consumers: credit origination, servicing, funding or forbearance, and risk bearing. Credit types can be quite different—closed-end or open-end, fixed or variable rate, secured or unsecured, large (home mortgage) or small (payday loan)—but these are "differentiations" among credit products that reflect differing mixes of product characteristics—and resulting prices. Yet at base, all of these transactions share a core of common characteristics that

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[60] Lancaster noted that the distinction between different and differentiated products is not always as easy or exact as one could wish:

> The distinction between differentiated products and different products can become somewhat shadowy. The term "product differentiation" is used here to mean variations in the characteristics contents of goods within the same closely defined group. In common terminology, product differentiates correspond to different "models" of automobiles or radios, whereas an automobile and a radio are products from different groups. The term "brand," used widely in marketing literature, is not properly synonymous with product differentiate, since there may be several models (and thus product differentiates) under a given brand name or identical products under different brand names.

Id. at 26.

distinguish extensions of credit from other products or financial services. Economically, the finance charge is the cost of providing these elements of deferred payment. Differences in these areas are what cause differentiation among credit types and, therefore, differences in the pricing of credit accounts.

Origination refers to all the cost-causing operating activities that are involved in booking the credit in the first place.[61] These activities may include evaluating and checking credit, any necessary interviewing of prospective customers, and establishing any needed documents and records. They also include marketing, printing forms, and any need for legal counsel in establishing a credit operation and booking credits, including compliance considerations.

For the different kinds of credit, origination costs for any particular kind of credit contract through a particular marketing channel, say credit cards through prescreened solicitations or automobile credit through a dealer network, are much the same for every customer. This means that costs are more closely related to the number of accounts than to the size of individual accounts. A doubling, for example, of the credit amount may call for some greater credit checking and other cost-causing actions, but not likely a doubling of the origination cost; this is a condition referred to as "scale economies" with respect to credit size. Since there are scale economies with respect to account size, origination costs per credit dollar decline as the amount of the credit increases. This explains why small loans are much more costly and carry higher APRs than larger loans: the necessary APR to cover the origination cost is much higher per credit dollar for smaller loans.[62] Costs can vary across marketing approaches, however, for example in-person loan interviewing versus over the Internet or present customers versus new ones.

Servicing refers to routine billing, receiving payments from consumers, handling inquiries and complaints, and managing the record keeping and accounting functions. For consumer credit, servicing normally involves the most unexciting part of the generally unexciting part of those operations usually known as the "back

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[61] *See* THE REPORT OF THE NATIONAL COMMISSION ON CONSUMER FINANCE, *supra* note 51, at 143-47 (discussing origination and servicing costs associated with consumer credit); *see also* Dagobert L. Brito & Peter R. Hartley, *Consumer Rationality and Credit Cards*, 103 J. POL. ECON. 400 (1995) (specifically discussing credit cards).

[62] *See* THE REPORT OF THE NATIONAL COMMISSION ON CONSUMER FINANCE *supra* note 51, at 143-47.

office." Servicing typically involves computer capabilities, auditing and controls, communications, and other ongoing aspects of the operating systems. Clearly, the pricing of consumer credit contracts must include coverage of the servicing aspects of the company, but, assuming the term "servicing" does not include cost of risk, servicing cost would tend not to vary much from one consumer's account to the next, at least for the same sorts of accounts serviced the same way. Under these conditions, periodic servicing activities and costs usually would not vary much by account, other things equal, although the total would be higher on accounts of longer maturity.

Servicing costs, however, can differ sharply between types of credit. Notably, there is a significant servicing distinction between typical closed-end credit and credit cards. After account origination, management of card accounts involves the need for instant record keeping for account and fraud control. Most importantly for general purpose cards like Discover, MasterCard and Visa, servicing requires instant communications capability to millions of merchant locations simultaneously, worldwide. This necessitates a much different cost structure from typical closed-end consumer credit, which, for the most part, can function without instant communications and records management. General-purpose card systems also require servicing the extensive networks of merchant locations, a side of the card business known as the "merchant" side or the "acquirer" side. It also requires establishing and maintaining networks of contractual relationships with millions of merchants in addition to millions of consumers. All of this is very expensive and quickly differentiates the cost structure of credit-card credit from other sorts of consumer credit.[63] Servicing costs also can vary by amount of labor effort involved, highly automated versus paper-based, for example.

Funding or forbearance involves the costs of the funds used in providing the credit to consumers, including the profit needed to assure continuous access to capital funds.[64] The need for funding gives rise to an immense industry that channels funds from savers who have resources available for use to borrowers who have current

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[63] *See generally* DAVID S. EVANS & RICHARD SCHMALENSEE, PAYING WITH PLASTIC (1999) (offering an interesting and readable account of the nature of modern credit card operating systems and the nature of the contractual agreements necessary to make them work).

[64] *See generally* EUGEN VON BÖHM-BAWERK, CAPITAL AND INTEREST, A CRITICAL HISTORY OF ECONOMICAL THEORY (William A. Smart, trans. Macmillan Co. 1890) (1884); *see also* IRVING FISHER, THE RATE OF INTEREST: ITS NATURE, DETERMINATION, AND RELATION TO ECONOMIC PHENOMENA (1907).

financial needs greater than currently available liquid capacity.[65] Typical consumer savings transactions take place through financial intermediaries like banks, savings and loans, credit unions, insurance companies, pension funds, mutual funds, and others that receive consumers' savings. These institutions then channel the resources back to the same or other consumers through retail credit establishments including banks, savings and loans, credit unions, finance companies, and sellers of goods and services. The channeling process is complex and sometimes even hard to understand, especially when it involves such modern borrowing devices among institutions as asset-backed securities, IO and PO strips, and other sorts of derivative instruments. But, the funding process has also become very efficient, with the ability to redirect immense amounts of resources as needed from ultimate lenders to ultimate borrowers. Without going into the complexities, it should be sufficient to note that the forbearance aspect of consumer credit is not the most significant cause of cost differences among kinds of credit for consumers. Again, leaving aside for a moment the issue of risk, there is no particular reason why an additional dollar of credit would be more expensive to a given consumer than the previous dollar on the basis of funding cost alone. In other words, there are no scale economies or diseconomies with respect to account size in forbearance on consumer credit.

The final fundamental service provided by creditors is risk bearing. It may be of more than one kind, for example credit default or "credit risk" versus market conditions or "interest-rate risk."[66]

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[65] Consumer credit provides an important outlet for employing financial resources available from net surplus components of the economy, notably from consumers themselves. In fact, if not in common perception, the consumer sector of the economy taken as a whole actually has always been a net lender in financial markets, not a net borrower. As revealed in the Federal Reserve's Flow of Funds accounting system, net financial investment by the economy's consumer sector (either directly or through intermediaries like banks and pension funds) passed the $1 trillion mark as long ago as 1958 (net of $183 billion of household liabilities at that time) and has continued to rise steadily ever since. Net consumer-sector financial investments totaled more than $24 trillion in current dollars at the end of 2003, when consumers' financial assets approximated $34 trillion and total liabilities were a bit under $10 trillion. Federal Reserve Statistical Release Z.1, Flow of Funds Accounts of the United States (Mar. 4, 2004), *at* http://www.federalreserve.gov/releases/Z1/20040304/. Even so, households obviously continue to borrow large amounts of funds, typically through financial intermediaries, sometimes from the same ones where they hold their reserves.

[66] *See generally* FRANK H. KNIGHT, RISK, UNCERTAINTY, AND PROFIT (1921) (discussing the general theory of credit risk versus interest-rate risk); Dwight M.

Default risk varies sharply by type of customer, but interest rate risk depends on overall conditions in national and even international financial markets and how the maturities and durations of institutions' entire portfolios of assets and liabilities are structured. This makes default risk the more important variable component of pricing on a typical, individual consumer credit transaction.

It is well known and obvious that consumers vary significantly on the basis of the likelihood that they will be able and willing to repay any given deferral of payment (credit). Clearly, the likelihood depends upon the amount of the credit, the security or collateral offered, the consumer's current and expected available resources—assets and income—and some undefined underlying psychological factors that determine both frugality and willingness to meet obligations. These differences lead to the art and science of credit evaluation or screening as an attempt to differentiate among good and bad credit risks. Without delving into how this is done, there is no question that it is central to consumer credit markets or that there has been technological change over time in how it is done. It has become evident to most observers that improvements in screening capabilities due to technology, such as credit scoring and automated credit bureaus, have recently permitted greater differentiation among risk groupings of consumers than in the past.

Differentiations along each of these fundamental features of credit arrangements—origination, servicing, funding, and risk bearing—produce a huge variety of consumer credit arrangements, each with its own distinct combination of individual characteristics. There are large loans and small loans, secured loans and unsecured loans, prime loans and sub prime alternatives, open-end and closed-end credit, and many variations of each. Whereas once it might have been difficult for creditors to produce such a multiplicity of products, today the capability readily exists. This means someone seeking a market niche is going to try to produce credit products with virtually any kind of combination of features that can be supplied profitably. In the resulting environment where variety is available, consumers are going to look for tailoring of product offerings. Otherwise, they will let someone else become their supplier. Since the combinations of the characteristics of the wide variety of resulting products vary directly along the dimensions associated with underlying cost differences, it should not be surprising that there is differentiation of

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Jaffee & Franco Modigliani, *A Theory and Test of Credit Rationing*, 59 AMERICAN ECONOMIC REVIEW (1969) (providing a general analysis of credit risk and the loan offer function).

pricing in the marketplace according to these characteristics. Most importantly, the price of credit is going to vary most according to the origination cost per dollar of credit advanced and because of the cost of risk. There also is going to be a sharp difference, other things equal, in costs of account servicing between closed-end and open-end credit.

4. Pricing Complexity

All this discussion of differentiation and complexity in the marketplace leads inevitably to the question whether it is really necessary at the consumer level. In a competitive marketplace with ongoing technological change the equally inevitable answer is going to be "yes." Economic theory projects this outcome, but it is quite intuitive for a simple reason: in a competitive marketplace with many available options, consumers are not going to be willing to pay for components they do not use, and they are going to have to pay for the components they do use, whether characterized as finance charges, "other charges," or something else under the legacy disclosure framework known as "truth in lending." Consumers are willing to pay for options when purchasing houses, cars, computers, sports equipment, college educations, and virtually everything else with multiple characteristics; why should credit be any different? Also, they generally are unwilling to pay for options they do not want or expect to use. Why should credit be any different on that dimension either?

As indicated, the economic reason for expanded numbers of available combinations of characteristics of credit arrangements is that they arise from the unwillingness of consumers to pay for the cross subsidies inevitable when separable characteristics of a transaction are priced jointly. The difficulty for creditors who might prefer otherwise is that trying to retain a system of such cross subsidies in a competitive marketplace increases the risk of losing the profitable customers to others offering a better deal. This happens all the time for all sorts of products, but it leads inevitably to additional complexity when the components of a smorgasbord are priced separately. Let us look at this more closely.

It obviously is not strictly necessary for producers or sellers to earn a profit on every separate component of a product with multiple characteristics or from every customer when there are multiple customers. The necessity is only that the totality of the enterprise's activities be profitable. It is also clear that some aspects of products—or even some complete products—can sometimes be

treated as loss leaders, or they can even become completely lost in the pricing shuffle, never considered to be possibly profitable by themselves. It usually is not necessary, for example, for there to be a specific price and profit associated with the acreage devoted to the parking lot for a typical financial firm. It often is possible to prosper while making "free parking" available to customers, and many firms do it. As long as the gain in net sales from providing the lot exceeds the cost due to it, the firm will devote resources to parking, and the small subsidy associated with free parking does not seriously complicate transactions.

But, failing to price important components of a transaction separately can lead to its own brand of complications. Significantly, it does not follow from the notion that products have multiple components, or from the idea that not all components need be priced separately all the time, that business firms can ignore how they price components of products and transactions. With competition, they cannot turn whole classes of separable components or products into loss leaders for other components or products through cross subsidies among their offerings. If firms held monopoly positions in the marketplace, they might be able to engage in substantial cross subsidies, but generally they do not have this luxury. Rather, almost all consumer-oriented sellers must face some sort of competition, and it always comes in the area where they are overpricing components or products.

One feature of a competitive marketplace is that it rarely permits sellers to mix the pricing of products through cross subsidies. There are many historical examples where profitability was based upon cross subsidizing loss leaders, but with development of competition, the opportunity quickly disappeared. It is easy enough to see why: cross subsidies encourage new competitors to enter the marketplace and compete but only on the profitable side of the cross subsidy. Left to themselves, market entrants simply refuse to compete on the other side, that is, in the component or product area where sales are made at a loss. Railroads in the nineteenth century and telecommunications in the twentieth century offer some very well known examples, but there are many others that are equally illustrative.[67]

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[67] In the nineteenth century, the railroads, in effect, owned the transportation industry. *See generally* MERTON J. PECK, *Transportation in American History, in* AMERICAN ECONOMIC HISTORY (Seymour E. Harris ed., 1961). There were competing rail systems to be sure, but they generally did not all go to the same places and there was little enough of competition between many end points and

Consumer credit and credit cards offer a twenty-first century example of the need to price for the services offered. In an earlier era when differential interest rate ceilings for different institutions tended to limit competition between institutional classes, such as between banks and finance companies, at a time when geography also generally limited competition among individual institutions, and when the primitive nature of credit underwriting and management systems meant it was difficult to differentiate carefully among consumers, creditors could, and usually did, charge all customers the

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especially on many low traffic branches. The only other real competition was from slow horse-drawn wagons or watercraft, where there were adequate roads or canals or navigable rivers and no ice to interfere. In this environment the rail companies tended to overprice on carrying products with high value relative to their bulk (like high-value manufactured goods and passengers) and on moving all commodities on branch lines where there was little or no competition. They then tended to underprice the transportation of bulk commodities on main lines, charging only enough to cover operating costs and overhead. This tended to build volume and revenues to cover costs for the system overall, but they earned their profits mostly from the high value goods and the monopoly branches.

What happened to the railroads is, of course, well known. In the twentieth century they faced new forms of competition, but precisely only on the overpriced services. Trucks, air freight, and the passenger automobile (all arising from technological change) competed away the transportation products where the railroads were overcharging, leaving the railroads with only the main line bulk commodities. Trucks and air freight never even attempted to seize traffic in coal and grain, of course, for the obvious reason that they could not possibly charge a price to undercut the rails in these areas. Many bankruptcies later, a few remaining railroads resurrected themselves in the later twentieth century as rapid, bulk-commodity haulers, but transportation will never again be like it was.

More recently, the same sort of thing happened in the telecommunications industry. For almost a century the American Telephone and Telegraph Company and its Bell System operating companies maintained almost a monopoly on domestic telephone service. To encourage widespread connection to the system, the Bell System tended to underprice local telephone service relatively, and it generated much of its profitability in the long distance service. When telecommunications opened to greater competition, the new competitors naturally gravitated toward competing only in the relatively overpriced long distance service and AT&T ceased to be the financial powerhouse it had been for so many decades. Technological change, evolving regulatory policies, and many other factors were important in making the telecommunications revolution of the past few decades, but there can be little question that the industry has changed and the end of cross subsidies was important in generating this change. Today the long distance market is highly competitive and (inflation adjusted) prices at the consumer level are much lower than they used to be. In contrast, local telephone service prices (now free of cross subsidy) are higher than they used to be. The important lesson for purposes here is that as competition has increased dramatically, the opportunities for cross subsidies simply have largely disappeared.

same price (interest rate) for the credit service offered. Individual applicants to a particular financial institution were either acceptable under the creditor's underwriting criteria or they were not. If an individual were accepted as a customer, he or she typically paid the same interest rate as every other accepted customer for the same amount of credit extended.

No longer is this approach to business possible in an era when technological change has made differential processing possible by making it significantly easier to screen risks into more gradations and to acquire and communicate easily with customers from afar. In this environment, increased competitiveness in the consumer credit marketplace has made it difficult to cross subsidize one group of consumers by charging some other group of customers too much. The attempt merely causes an influx of competition, but only in the area of the overcharge. No one is going to rush into a market to seize only the loss leaders.

Instead, they are going to compete in the part of the market where there is overpricing. Unlike many years ago when creditors charged everyone the same amount, today technology permits much finer gradations in the characteristics of the credit services offered. The most important changes have involved improvements in ability to make gradations of risk, but there are other changes as well. In the risk management area, credit scoring, computerized record keeping, automated credit bureaus, and rapid communications permit creditors to charge different risk groups more carefully on the basis of the risk-related characteristics they exhibit.

Most consumers realize there have been improvements in the ability to judge risk, especially those who benefit from the new regime. Lower risk consumers are bombarded by offers such as prescreened credit card solicitations and offers of refinanced home mortgages and home equity loans at low rates until they are largely unwilling to pay more than a minimum. Millions of consumers will rapidly refinance their home mortgages when interest rates drop, even if they drop only a handful of basis points. Lower risk consumers also know they can easily change credit card accounts or open new ones.[68] Simply put, any creditor who attempts to charge large numbers of consumers more for credit than their risk status requires will lose business. It would be nicely profitable to charge low risk customers

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[68] Durkin, *supra* note 51, at 629 (showing that approximately eighty-five percent of holders of bank-type credit cards believed it would be easy for them to obtain another card if not treated well by their card issuer, according to a 2000 consumer survey).

high prices for credit, but there is no indication this is any longer a very easy thing to do.[69]

5. Pricing by Characteristics

If creditors are not routinely able to engage in extensive cross subsidies among credit products, among the components of individual products, or between credit products and other offerings, then how are they going to base their pricing? The answer that should be becoming clear by now is that in a competitive marketplace they are going to have to price individual products, whether credit or not, on the basis of the characteristics of those products.[70] As developed here, this means that the price for credit will be based upon the characteristics associated with origination, servicing needs, funding, and risk. Loss leaders and cross subsidies in limited areas or for low cost or infrequently found characteristics of products are still possible, but opportunities along these lines are going to be limited. If creditors offer other products that are not credit, including associated products and services or others less closely related, but products or services that not all customers will want to purchase as part of or associated with their own credit arrangements, they generally will have to price them separately as well. Then they also will have to ensure that the totality of the arrangements passes muster under prevailing disclosure requirements, for consumer credit notably truth in lending.

What are some examples of the sorts of difficulties that arise for making disclosures? An obvious one is that credit must be differentiated from other products and services. Truth-in-lending requires disclosures of the pricing of credit, but it is necessary to separate credit properly from other products and services in order to disclose properly the pricing of the credit aspect of the entirety of the transaction. In some cases this is not going to be easy or the

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[69] Pacelle, *supra* note 12, at A1 ("Gone are the days when banks collected hefty annual fees on all credit cards and charged fat interest rates to all consumers. Now, the banks say, they must rely on risk-based pricing models under which customers with the shakiest finances pay higher rates and more fees."). For a broader view of competition among card issuers, *see* Todd J. Zywicki, *The Economics of Credit Cards*, 3 CHAP. L. REV. 79 (2000) (discrediting the theory that the credit card industry is fundamentally noncompetitive).

[70] *See* TIMOTHY P. ROTH, THE PRESENT STATE OF CONSUMER THEORY (2d ed. 1989) (providing a readable discussion of the development of this theory). *See also* H. A. JOHN GREEN, CONSUMER THEORY (1976) (giving a more advanced discussion of the theory).

separating lines crystal clear. Before discussing how this might be done for open-end credit plans, it seems worthwhile to look at some of the features of modern open-end credit arrangements that illustrate the difficulties involved.

B. Characteristics of Modern Credit Card Plans

1. Range of Offerings

Open-end credit plans, which will be the focus here, typically have even more components than closed-end credit, to the extent that one can say a typical credit card plan is less a financial transaction and more a living financial relationship, in which a credit extension is embedded but which contains many other ingredients. Consider the possible features of a typical bank credit card arrangement. The cardholder has a credit line which can be drawn upon anywhere in the world—the credit cornerstone of the relationship. But the cardholder can also use the card as a transaction device, a cash substitute, by paying off balances without revolving, although this arrangement is still credit in the sense that purchase and payment are still separated by a short time. The card also serves other non-credit functions for the customer, such as identification and affinity-group participation. The cardholder may also use, and value, other aspects of the card relationship, such as a variety of insurance products, credit or other life or health coverages, casualty or replacement insurance for goods purchased, frequent flyer miles, travel club privileges, merchandise credits, and the list goes on. Consumers with home equity credit lines underneath their credit card realize tax deductions for interest paid. Even within the credit feature itself, customers may opt for an upgraded plan, skip-payment privileges, annual expense summaries, linkage to a deposit account, automated clearing house ("ACH") payments, overdraft privileges, and so on. Unlike closed-end credit, open-end plans contemplate periodic statements, usually monthly, that are not only collection mechanisms but ready-made marketing platforms.

For the card issuer, the card plan relationship is also a broad marketing opportunity for products not directly related to credit services. It starts with the credit line as a discrete financial product, but includes the marketing of countless other products and services through statement stuffers, special mailings, and telemarketing.[71] By

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[71] The FTC/FCC Telemarketing Registry ("Do-Not-Call") rules do not apply

virtue of the information-sharing provisions in the Fair Credit Reporting Act,[72] a card issuer can routinely share customer information among its corporate family and with third-parties, generating continuing circles of marketing opportunities. Increasingly the bank card relationship becomes the platform to market investment products. Periodic account monitoring through credit reports allows the card issuer to increase credit lines, send convenience checks, and otherwise influence the card holder's use of the plan.

A card issuer's roster of financial and related services may resemble a Wal-Mart of product offerings and customer choices. Some items are high mark-up, some less so; as mentioned, other features may even sometimes be loss leaders.[73] Some products clearly constitute or implicate an extension of credit (the basic credit line), others are only marginally related to the existence and maintenance of the credit line (fraud loss insurance), and still others seem clearly distinct and separate from the credit plan (mutual funds promoted to card holders through statement stuffers or telemarketing).

Across this storehouse of credit card offerings and features, and related products and services, the card issuer can modulate its revenue stream in a variety of ways, and may be largely indifferent as to the precise source of the revenue so long as portfolio targets are met. Even considering that the card issuer's basic product is the credit line, and the basic pricing mechanism is the applicable interest rate or APR, this explicit rate is only one of a range of pricing variables the creditor may employ. To change the APR revenue stream, the card issuer can, of course, adjust the explicit periodic rates and APRs. It can also: (1) add or increase an annual or membership fee; (2) adjust merchant discounts and interchange fees;[74] (3) adjust the balance assessment methods applied to determine the periodic balance subject to finance charge;[75] (4) reduce or eliminate grace periods; (5) shrink

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where there is an "established business relationship" with the consumer. *See* FTC Telemarketing Sales Rule, 16 C.F.R. § 310.4(b)(1)(iii)(B)(ii) (2004); FCC Restrictions on Telemarketing and Telephone Solicitation, 47 C.F.R. §§ 64.1200(c)(2), 64.1200(f)(9)(ii) (2004).

[72] Fair Credit Reporting Act § 624, 15 U.S.C. § 1681s-3(4)(c) (2004), *amended by* Fair and Accurate Credit Transactions Act of 2003, Pub. L. No. 108-159, § 214(2), 117 Stat. 1952 (2003).

[73] Initially discounted or teaser rates, for example.

[74] The latter would require cooperative or directive action by the credit card network as a whole.

[75] Commentary ¶¶ 5a(g)-1, 5a(g)-2 (describing various balance assessment methods).

the payment period;[76] or (6) add or increase fees for actual or nominal delinquencies.[77]

To this list[78] we can add another category: (7) offer separate products or services to customers on an optional basis, rather than as contractually mandatory terms of the credit. Revenue flows from this category will be as substantial as the creditor can induce or persuade customers to opt for the add-on item. The recent FRB rulemakings on expedited payment or expedited delivery of a card are current examples.[79] A cardholder may be willing to pay an extra fee to have a payment processed quickly and electronically, to avoid a late charge or simply as a matter of convenience. A cardholder may agree to pay a fee to have a replacement card delivered by overnight courier. Each such ancillary service can carry a price, and in the aggregate these services may generate substantial income separate from the basic interest rate and related fees applicable to the credit plan. The question is their position within the TILA structure.

The phenomenon of card issuers offering and charging fees for ancillary products and services is part of the trend toward "unbundling" the creditor's pricing structure discussed above, both to increase revenue and to distribute costs more explicitly to those consumers who cause them. If the card issuer did not, or could not, charge a separate fee for expedited payment or expedited card delivery, the card issuer might absorb the cost of providing those

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[76] If the periodic statement were sent promptly on the close of a billing period, the customer would theoretically have almost a month to make the required payment before the end of the new billing period. But the law only requires that the statement be mailed at least fourteen days before the payment due date. Regulation Z § 226.5(b)(2)(ii). Allowing for several days in the mail at each end, this means the customer may have barely a week to mail in the payment to avoid a late charge. This shrinking payment period can boost revenue by getting payments in hand earlier and by generating more late payment fee income.

[77] *See* Pacelle, *supra* note 12 at A1 (including such fees as those for late payments, accounts over the limit fees, bounced checks and non-revolving balances).

[78] This list contemplates open-end offerings by banks in the form of credit cards, home equity lines, and the like. If the creditor is itself a retail merchant, it can manipulate revenues in another variety of ways through the pricing of its goods or services independently from the credit line that finances their purchase. Most major retailers now offer their credit cards through a bank affiliate, at least in part to take advantage of rate-exporting privileges available to federally insured depositories. But the synergy between the retailing and financing arms remains real.

[79] *See infra* Part IV.B.2.b.

services in its general overhead and reflect that new cost in an increased periodic rate. But this increased rate would be paid by all customers and not just by those who opt for the service. In lieu of this kind of cross subsidization, the card issuer could choose not to offer the services at all, at the risk of customer dissatisfaction and competitive disadvantage. More likely, the provider is going to want to price its products and services in a way that adds to its business volume rather than drives its customers away. This means charging only those who purchase extra goods or services the price of those additional goods and services. If these goods and services are not credit, then their prices are not finance charges.

2. The Finance Charge: What is the Cost of Credit?

What, then, constitutes a finance charge under TILA? In particular, how does the economic concept of the finance charge as the cost of credit relate to the finance charge as a legal concept within TILA? As discussed, the economic concept of the finance charge is the cost of deferring payment for resources received now in the form of goods and services (sales of things on credit) or cash (cash loans). The cost of deferred payment arrangements arises from expenses due to origination, servicing, funding, and risk. Consequently, payment for these characteristics of a transaction totality that includes deferred payments is the economic conception of the finance charge as the cost of credit, and so it follows that payments for them should constitute the finance charge under TILA; other payments even if associated with credit arrangements are costs and payments of something else. As indicated, separating the totality of transactions into their components is not always so simple, however. When Congress decided that the costs of the credit component of the totality would henceforth be disclosed to consumers in specified formats, this decision led to many of the complications and legal decisions that have been the history of TILA.

For credit cards most of the costs of the credit arrangements have been within the scope of the disclosed finance charge since the earliest days of TILA in 1968. Much of the cost of origination, servicing, funding, and risk is assessed to consumers through application of a periodic percentage to a balance outstanding, or through assessment of transaction charges required under some plans. Some other sources of revenue have never been considered finance charges, however, for both conceptual and practical reasons. Interchange fees or discounts assessed to merchants whenever the

card is used are not finance charges, for example.[80] They are not directly assessed on consumers; they are more properly considered part of the operating costs of the merchants. As such, they more properly become part of the cost of the goods sold on credit cards. They are similar to the merchant costs associated with accepting cash and checks in exchange for goods and services, including accounting, reconciliation, fraud prevention and control, and physical security.

Within this guideline, the fees noted by Regulation Z as "other charges," or neither finance charges nor "other charges," would appear to be correctly classified in an economic sense. They are not fees assessed for normal expenses of origination, servicing, funding, or risk. Arguably, late payment, over-limit, and default fees are associated with riskiness of accounts, but they arise from events subsequent to initiation of the account relationship when initial disclosures are provided. In that sense they are like charges that are subsequent events on closed-end credit that do not require re-disclosure. It seems such charges are increasingly prevalent today because of the needs of card companies to retain their best customers by not cross subsidizing those who cause higher costs by paying late or otherwise defaulting. Late paying and otherwise riskier customers also typically pay higher percentage rates today. But, card companies simply are no longer able to charge all customers the same percentage rate and cover the higher costs due to the late payers from general revenues available from percentage rates charged to balances. The lower risk customers would simply gravitate toward card issuers maintaining only a prime portfolio and charging those better customers lower rates. Regardless of whether such charges seem correctly classified, there has been considerable controversy over these classifications since 1968, and it continues today. Before returning to discussion of general principles that might be applied to defining finance charges, it seems worthwhile to review further development and current status of the law in this area.

It seems inevitable that creditors will consider the legal disclosure consequences of whatever combination of pricing strategies they want to deploy. If the costs of incidental or ancillary products and services, offered to customers on an optional basis, must be treated as "finance charges" or as "other charges," creditors may see the compliance burden and liability risks as disincentives to offering those products or services. This is especially true if the charges must be treated as finance charges - they must be factored into disclosed APRs, including the historical APR in open-end

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[80] Commentary ¶ 4(a)-2.

credit.[81] At some level at least, this would force creditors to compete on the basis of that derived, unit-cost-of-credit percentage rate, whether they want to or not. All of this highlights the importance of the question here: What is a TILA finance charge or what should it be other than a response to some disclosure requirement or some sort of compliance convenience?

IV. The State of the Law: Optional Fees as Finance Charges, Or Not?

This section seeks to sort out, from regulatory rulings and case law, what is the prevailing interpretation on the issue whether charges for optional products or services are finance charges or something else.

A. What is a Finance Charge? The Definitional Structure

1. The Basic Definition

To assess whether any charge, including particularly a charge for an optional product or service, is a TILA finance charge, the starting point is the statutory and regulatory language. According to Regulation Z:

> The finance charge is the cost of consumer credit as a dollar amount. It includes any charge payable directly or indirectly by the consumer and imposed directly or indirectly by the creditor as an incident to or a condition of the extension of credit. It does not include any charge of a type payable in a comparable cash transaction.[82]

The general approach, therefore, is all-inclusive. Any charge "imposed . . . as an incident to or a condition of" the credit is a finance charge.[83] The regulation goes on to enumerate ten types of charges that are finance charges; these are examples rather than an all-inclusive list.[84] Then, the regulation explicitly carves out a

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[81] *See supra* Part II.

[82] Regulation Z § 226.4(a).

[83] *Id.*

[84] *Id.* § 226.4(b) is captioned "Examples of finance charges," *cf.*, Commentary ¶ Introduction-4(a).

number of charges that are not to be treated as finance charges.[85] These represent various compromises or adjustments to what might be a purist approach to economic characterization; most of these compromises or adjustments have been in TILA since its birth, although several are more recent additions. A complete parsing out of the finance charge definition is a lengthy and complex undertaking.[86] Suffice it to say that most of the debate, litigation, and interpretational gloss on the TILA finance charge definition has to do with whether a charge clearly required by the creditor as a condition of the credit fits into one or another of the specific categories of inclusion or exclusion.

2. The Credit Insurance Model

Although there is nothing in Regulation Z or the Commentary that addresses charges for optional products or services as a generic category, there is one example of such a charge that has been treated explicitly in the Act and regulation since 1968: premiums for credit insurance. Credit insurance pays off all or a portion of a credit obligation if the consumer dies, becomes ill or disabled, loses employment, or has some other impediment to payment.[87] It therefore represents a value-added for the consumer—his family or survivors are excused from responsibility for the debt. At the same time, the creditor's collection risk is reduced by virtue of the insurance, and the creditor may also realize substantial income from sales of credit insurance, through commissions, experience rebates and the like. Historically, lawmakers have been concerned about the "reverse competition" dynamic in the marketing of credit insurance—creditors are inclined to offer more expensive, rather than cheaper, coverages—and are also inclined to hard-sell the credit insurance despite its ostensibly voluntary character.[88] Still, the content of the

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[85] Regulation Z § 226.4(c).

[86] *See* ROHNER & MILLER, *supra* note 6, ch. 3; *see also* National Consumer Law Center, *supra* note 6, at ch. 3.

[87] "Credit insurance," as the term is commonly used, is different from private mortgage insurance or other forms of insurance against credit loss, which pay the creditor when the consumer defaults, regardless of the reason for the default. Credit *loss* insurance premiums are always a finance charge. Regulation Z § 226.4(b)(5). Economically they are payment for the creditor's risk bearing. Credit insurance is more limited in scope in that it frees the consumer, or the consumer's estate, from risk due to a limited number of specified contingencies.

[88] Litigation over the voluntariness of credit insurance may have peaked in US

product is regulated to a degree by the state insurance commission. The rule for credit insurance reflects these concerns. Credit insurance premiums are prima facie finance charges whenever "written in connection with a credit transaction."[89] But the premiums are excluded from the finance charge if (1) the insurance is not required by the creditor, is voluntary on the consumer's part, and the creditor discloses that fact; (2) the creditor discloses the initial term of coverage and the amount of the premium; and (3) the consumer, in writing, separately authorizes the purchase.[90]

Here is one model for dealing with charges for optional products or services—presumptively include their cost in the finance charge when they represent underlying characteristics of the credit transaction itself, but carve them out where there are safeguards to assure that the consumer's purchase is truly voluntary.[91] But because this model rests in the statutory text, and applies by its terms only to credit insurance, it cannot easily be transposed to other voluntarily incurred products or services.[92]

Life Credit Corp. v. Federal Trade Comm'n, 599 F.2d 1387 (5th Cir. 1979), *reh'g denied*, 604 F.2d 671 (5th Cir. 1979), and Anthony v. Cmty. Loan & Inv. Corp., 559 F.2d 1363 (5th Cir. 1977). These cases suggest that, although voluntariness remains a factual question, a consumer is usually bound by the purchase authorization he or she signed. *See* Commentary ¶ 4(d)-5. More recently, the packing of credit insurance into high-priced mortgages, particularly where the lump sum insurance premium for a limited term is financed over the life of the mortgage, has been cited as part of the "predatory lending" problem. U.S. Departments of Housing and Urban Development and Treasury, *Curbing Predatory Home Mortgage Lending: A Joint Report* (June 2000), *available at* http://www.treas.gov/press/releases/report3076.htm.

[89] Regulation Z § 226.4(b)(7).

[90] *Id.*

[91] The TILA treatment of property insurance, i.e., casualty coverage on property, is roughly similar, in the sense that the creditor may require such coverage, but to exclude the premium from the finance charge the creditor must disclose that the consumer can obtain the coverage elsewhere, and must disclose the price and term if the insurance is furnished by the creditor. Regulation Z § 226.4(d)(2). The regulatory provision does not literally say that it is limited to insurance on property serving as collateral for the loan, but that is its obvious context. What, then, if a creditor offers optional casualty coverage, or "replacement protection," for goods purchased on an unsecured credit card line? Must the creditor still jump through the disclosure hoops just noted, or may the creditor treat this optional purchase as completely outside the finance charge definition? An old staff letter said yes. FRB Letter No. 378, CCH Cons. Credit Guide ¶ 30,559 (July 29, 1970). There is no more current view, certainly not a contrary one.

[92] Sometimes creditors offer life or health insurance coverages that are not

B. Interpretational Guidance: 1968-2004

1. Early Board Staff Opinions

Other than the credit insurance model just discussed, for almost thirty years after TILA's enactment, there were only fragmentary signals from the FRB or the courts[93] on the proper treatment of charges for optional products or services. Absent explicit guidance, some creditors and their attorneys took a certain comfort level from the basic statutory and regulatory language defining finance charges as "imposed" by the creditor. Under this view, unless the purchase of the product or service was mandatory, a required condition to the extension of credit, the charge did not represent a cost of the credit, and was not a finance charge.[94] The weight to give this general sentiment is debatable; it may have been no more than keeping one's interpretational fingers crossed. The credit insurance model, discussed above, at least technically rejects this view.

Prior to the "simplification" of TILA in 1980, and the complete re-writing of Regulation Z and introduction of a staff "Commentary" in lieu of interpretational letters, there were a number of FRB staff letters suggesting that certain fees were not finance charges if the product or service purchased with the fee was an optional add-on to the credit contract. The apparent rationale is that a voluntarily assumed charge for an ancillary product is not incident to

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"credit insurance" because neither the creditor nor the consumer's account are the loss beneficiary on the policy; the benefits may be fully payable to the consumer or to the consumer's survivors, for example. Commentary & 4(d)-6 recognizes that "[i]f such insurance is not required by the creditor as an incident to or condition of credit," it is not a finance charge. In this carve-out, the Commentary in fact is recognizing the principle that associated sales of products unrelated to credit origination, servicing, funding, or risk, are not costs of credit. Commentary ¶ 4(d)-6.

[93] One of the few cases is Veale v. Citibank, F.S.B., 85 F.3d 577 (11th Cir. 1996), where the court held that a courier fee (for disbursing loan proceeds) was optional and therefore not "incident to" the credit extension. *Id.* This holding may now be affected by the 1996 statutory and regulatory revisions that address third-party closing agent charges. Under current Regulation Z § 226.4(a)(2), the courier charge is a finance charge if the creditor requires either the service or the charge, or shares the fee with the third-party.

[94] The authors do not have a scientific sampling of this creditor rationalization but can recall numerous conversations with creditors or their lawyers who took it as gospel that charges for truly optional products or services could not be finance charges.

or a condition of the credit. Examples include:

1. A two dollar monthly charge for a package of banking services (free checking, safe deposit box, etc.) that included a credit card account—not a finance charge[95]

2. A fee for "voluntary purchase" of a copy of an amortization schedule—not a finance charge[96]

3. A fee for copies of sales slips the customer wants for bookkeeping purposes—not a finance charge[97]

4. A voluntarily incurred fee for storage of a fur coat serving as loan collateral—not a finance charge[98]

While these old letters are officially "superseded" by the new Regulation Z and the Commentary,[99] they do suggest that the FRB staff recognized some limits to an all-inclusive approach to the finance charge definition. Since the core of that definition has not changed since 1968, these staff views retain some relevance. None of these early letters appear to articulate the view that charges the consumer voluntarily incurs are "imposed" within the finance charge definition, or even that optionally incurred fees are presumptively finance charges.

During the 1970s, the FRB staff also developed the notion that charges payable in a comparable cash transaction, whether optional or required, were not finance charges because they were not distinctly related to the credit extension.[100] Sales taxes and tag-and-title fees were the leading examples. This "comparable cash transaction" limitation is codified in the revised statute,[101] appears also in Regulation Z, and is the subject of extensive elaboration in the

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[95] FRB Staff Letter 715, CCH Cons. Credit Guide ¶ 31,014 (Aug. 24, 1973).

[96] FRB Staff Letter 643, CCH Cons. Credit Guide ¶ 30,904 (Nov. 2, 1972).

[97] FRB Staff Letter 1035, CCH Cons. Credit Guide ¶ 31,375 (Apr. 22, 1976).

[98] FRB Staff Letter 773, CCH Cons. Credit Guide ¶ 31,095 (Apr. 4, 1974).

[99] Commentary ¶ Introduction-3.

[100] *See e.g.* FRB Official Staff Interpretation No. FC-0018, 41 Fed. Reg. 51391, CCH Cons. Credit Guide ¶ 31,486 (1976).

[101] Truth in Lending Act (TILA) § 106(a), 15 U.S.C. § 1605 (2004).

Commentary.[102] One of the examples given is a charge for a service policy or auto club membership, implicitly incident to the sale and financing of an automobile.[103] Such add-on purchases are typically offered on a voluntary basis, and the Board staff might have excepted them from the finance charge on that basis, in parallel with the earlier staff letters. Including them in the "comparable cash transaction" exception, however, makes sense to cover even required add-on purchases of this type, such as sales taxes.[104]

On reflection, the comparable cash transaction criterion for excluding charges from the finance charge may be nothing more than a euphemism for saying that the charge is really not for the credit at all, but reflects a separate purchase only temporally connected to the extension of credit. Tag-and-title fees, or sales taxes, may be unavoidable—required—for anyone purchasing a new car, but that expense satisfies the motor vehicle department or the tax collector and has no bearing on the terms of the credit buyer's loan obligation. In any case, it is difficult to invoke the comparable cash transaction reference point in evaluating a post-account opening charge in an open-end credit plan, such as for expedited payment or expedited delivery of a card; there simply is no cash transaction to which to compare it.

From 1980 until 1995 the issue lay largely dormant. The Commentary, from its inception in 1981, recognized two instances of a "voluntary" charge that was not a finance charge—for documentary evidence, such as sales slips,[105] and for non-credit insurance premiums[106]—but that was it from the FRB and its staff. Moreover, there is virtually no reported case law dealing with charges for optional products or services in the entire period from 1968 through the mid-1990s. But in late 1995, the FRB "went public" with its views on charges for optional products or services.

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[102] Commentary ¶ 4(a)-1.

[103] Commentary ¶ 4(a)-1-i-D.

[104] But note that "[c]harges for a required maintenance or service contract imposed only in a credit transaction" *would* be finance charges. Commentary ¶ 4(a)-1.ii.C.

[105] *Id.* ¶ 6(b)-2.

[106] *Id.* ¶ 4(d)-6.

2. The Post-1995 Interpretational Morass

a. Round 1: Debt Cancellation Agreements

In December 1995 the FRB proposed new Commentary[107] to deal with "debt cancellation agreements," described as follows:

> In the case of motor vehicle loans, debt cancellation agreements [DCAs] (sometimes referred to as "gap" agreements) offer protection to consumers in the event the vehicle is stolen or destroyed and the motor vehicle insurance proceeds are insufficient to extinguish the debt. Under these agreements, in return for a fee paid, the consumer is not held liable for the remaining balance on the loan. Other types of agreements may provide for debt cancellation if the borrower dies or becomes disabled. In some states, debt cancellation agreements may be regulated as or otherwise considered insurance contracts.[108]

The proposed Commentary built on the insurance characterization. If the DCA were treated as insurance under state law, the fee could be excluded from the finance charge under the existing regulatory provision dealing with credit insurance. But, the proposal suggested, if state law did not treat DCAs as insurance, then the fee would be a finance charge.

> [D]ebt cancellation fees paid to a creditor are treated as finance charges because they are charged by the creditor as an incident to the extension of credit and, although optional, the fees are not of a type payable in a comparable cash transaction.[109]

In other words, according to the proposal, a charge is "imposed," within the finance charge definition, whenever it is incurred by the consumer in connection with the credit transaction, even if voluntarily. The reference to a "comparable cash transaction" suggests that the FRB staff saw that as the sole escape hatch for optional fees—they would be excluded from the finance charge only

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[107] Truth in Lending, 60 Fed. Reg. 62,764 (Dec. 7, 1995).

[108] *Id.* at 62,764-65.

[109] *Id.* at 62,765 (emphasis added).

if the same fees would be paid in cash purchases.

At almost the same time, the FRB, responding to a congressional directive,[110] solicited comments on "how the finance charge could more accurately reflect the cost of consumer credit."[111] In this request, the FRB again made clear its position on optional charges:

> The term "imposed" [in Regulation Z § 226.4(a)] is interpreted broadly, to include any cost charged by the creditor (unless otherwise excluded), including charges for optional services paid by the consumer.[112]

The FRB had drawn its line in the sand. Presumably to prevent customer charges from leaking out of the finance charge into fees for "optional" services, the FRB's position was clear enough—incurred means imposed. What remained to be seen was how the FRB's principle plays out in real cases.

The initial DCA proposal was withdrawn in 1996,[113] on the ground that DCAs should be treated in parallel with credit insurance, regardless whether DCAs were insurance under state law, and that this required an amendment to Regulation Z itself, not just the Commentary.[114] When the regulatory proposal appeared a few months later,[115] the proposed treatment of DCAs would be consistent with that for credit insurance. DCA fees were expressly included in the list of examples of finance charges,[116] but the fees could be excluded from the finance charge if the creditor made essentially the same disclosures as for credit insurance.[117]

The FRB finalized this regulatory change for DCAs in September 1996.[118] Although the practical effect of the change was

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[110] Truth in Lending Act Amendments of 1995, Pub. L. No. 104-29, § 2(f), 109 Stat. 271 (1995).

[111] Truth in Lending, 60 Fed. Reg. 66,179 (Dec. 21, 1995).

[112] *Id.* at 66,180.

[113] Truth in Lending, 61 Fed. Reg. 14,952 (Apr. 4, 1996).

[114] *Id.* at 14,953.

[115] Truth in Lending, 61 Fed. Reg. 26,126 (May 24, 1996).

[116] Proposed 12 C.F.R. § 226.4(b)(10), 61 Fed. Reg. at 26,127 (May 24, 1996).

[117] *Id.* at 26,128.

[118] Truth in Lending, 61 Fed. Reg. 49,237 (Sept. 19, 1996). A credit insurance company unsuccessfully challenged this amendment to Regulation Z, on the ground

that DCA fees would not be treated as finance charges, the FRB took pains to elaborate further on its baseline "incurred means imposed" position:

> The Board believes that a debt cancellation fee charged by the creditor satisfies the definition of a finance charge because it is part of the cost of the credit. The TILA defines a finance charge to include any charge imposed as an incident to the extension of credit. The Board has interpreted this definition to include any fee charged by the creditor in connection with the loan, if it is not charged in comparable cash transactions and is not subject to an express exemption. *The Board has generally taken a case-by-case approach in determining whether particular fees are "finance charges," and does not interpret Regulation Z to automatically exclude all "voluntary" charges from the finance charge.* As a practical matter, most voluntary fees are excluded from the finance charge under the separate exclusion for charges that are payable in a comparable cash transaction, such as fees for optional maintenance agreements or fees paid to process motor vehicle registrations. In the case of debt cancellation agreements, however, the voluntary nature of the arrangement does not alter the fact that debt cancellation coverage is a feature of the loan affecting the total price paid for the credit.[119]

Interestingly, while this regulatory amendment was pending, the courts got their first real opportunity to weigh in. In McGee v. Kerr-Hickman Chrysler Plymouth, Inc.,[120] the federal appellate court confronted the same issue the FRB was facing administratively—are debt cancellation fees finance charges or not? In the court's view, they were not. Rejecting the argument that the only optional fees excludable from the finance charge are those incurred in a comparable cash transaction, the court saw the question as "whether the charge was required to obtain the particular credit terms that were

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that the Board had exceeded its statutory authority by extending credit-insurance status to products that were not in fact credit insurance. Am. Bankers Ins. Group, Inc. v. Fed. Reserve Bd., 3 F. Supp. 2d 37 (D.D.C. 1998). The court found that the Board had acted within its broad range of regulatory authority under TILA § 105, 15 U.S.C. § 1604.

[119] Truth in Lending, 61 Fed. Reg. at 49,239 (emphasis added).

[120] McGee v. Kerr-Hickman Chrysler Plymouth, Inc., 93 F. 3d 380 (7th Cir. 1996).

selected."[121] It answered the question by reasoning:

> GAP [the form of DCA involved] affects the relationship between the parties in the event that total loss insurance coverage is inadequate to meet the borrower's remaining loan debt, not the credit terms of the actual loan between the parties. Therefore, the GAP fee was properly included within the "Amount Financed" disclosure in the sales contract and excluded from the "Finance Charge" disclosure. TILA's purpose of assuring consumers an opportunity for meaningful comparison of different available credit terms is not undermined unless the argued-for disclosure actually involves credit terms.[122]

The contrast between the FRB's view and the court's is sharp, and might have sparked an ongoing debate between the regulators and the judiciary. But the FRB's amendment to Regulation Z, treating DCAs like credit insurance, moots the specific point in the case.[123]

So, in round one, the FRB preserved its principle, while de facto allowing optional DCA fees to be excluded from the finance charge.

b. Round Two: Expedited Payments and Card Delivery

In the late 1990s, credit card issuers began pressing the FRB for clarification of the proper treatment of several common types of charges applicable in card plans. The two examples that surfaced[124] were (1) a fee for arranging an expedited payment on a customer's account to avoid delinquency or accelerate collection, typically through an ACH transfer; and (2) a fee for expedited delivery of a new or replacement credit card as by overnight courier rather than

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[121] *Id.* at 384.

[122] *Id.* at 385.

[123] The court, anticipating the amendment, acknowledged as much. *Id.* at 385 n.10. Consumer lawyers applauded the Board for sticking to its policy premise that optional fees are "imposed" and therefore are finance charges. National Consumer Law Center, TRUTH IN LENDING 107, ¶ 3.6.4 (4th ed. 1999) ("[T]he Board explicitly and unequivocally rejected *McGee's* reasoning—the notion that voluntariness alone determines what is and is not a part of the finance charge .... This expression of the Board's position, given the deference it commands by courts, should be persuasive.").

[124] These examples may have been surrogates, or stalking horses, for a wide range of optional services that card issuers offered or are considering offering.

regular mail. Each is voluntary in the sense that the customer remains a customer, on the same contractual terms, whether the customer elects the expedited service or not. Are such fees finance charges, or "other charges," or do they fall into the third bucket of "not 'other charges'"?

The FRB staff had been informally advising that expedited payment fees were probably finance charges, on the incurred-means-imposed principle described above, while the expedited card delivery charge might be a "reissuance fee" which is in the list of "not 'other charges.'"[125] The FRB's Commentary clarification proposed in December 2002,[126] however, acknowledged that "the proper characterization of these fees under TILA previously has been unclear."[127] It then suggested that a fee for expediting a payment did not seem to be "incidental to the extension of credit if this payment method is not established as the regular payment method for the account,"[128] and so concluded it was not a finance charge. But the proposal went on to say that, because "[t]he charge appears to be a significant charge related to the credit plan,"[129] it should be treated as an "other charge."[130] A fee for expediting delivery of a card, the FRB staff proposed to confirm, was neither a finance charge nor an "other charge."

In the final version of this Commentary amendment, both the expedited payment and expedited delivery charge were relegated to the "not 'other charge'" category. The FRB staff effectively conceded that neither was "incidental" to the credit plan, nor a "significant" fee

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[125] Commentary ¶ 6(b)-2.

[126] Truth in Lending, 67 Fed. Reg. 72,618 (Dec. 6, 2002).

[127] *Id.* at 72,618. This lack-of-clarity concession may have been intended to reduce the litigation or examination exposure of card issuers that were not treating these charges as "finance" or "other" charges. In this connection a former banker observed that examiners from the three federal bank agencies (FRB, FDIC, and OCC) were taking different, inconsistent positions on whether various voluntary service fees were finance charges. E-mail from Trent Sorbe to Nathaniel Butler, Esq., August 13, 2002 (copy on file with authors), excerpted in Mr. Butler's comments to the FRB.

[128] Truth in Lending, 67 Fed. Reg. at 72,618.

[129] *Id.* at 72,619.

[130] *See supra* text accompanying notes 39-46. "Other charges" must be specifically disclosed to customers at several points, and usually an addition of or change in an "other charge" requires a change-in-terms notice. The Board proposed to exempt expedited payment fees from change-in-terms notices. Proposed Commentary ¶ 9(c)(2)-1.vi.

"related" to the plan. But each of these designations was closely hedged. The Commentary language for expedited payment speaks of

> A fee charged for arranging a single payment on the credit account, upon the consumer's request (regardless of how frequently the consumer requests the service), if the credit plan provides that the consumer may make payments on the account by another reasonable means, such as by standard mail service, without paying a fee to the creditor.[131]

For the exclusion of expedited card delivery fees, the Commentary describes

> A fee to expedite delivery of a credit card, either at account opening or during the life of the account, provided delivery of the card is also available by standard mail service (or other means at least as fast) without paying a fee for delivery.[132]

So, two more specific examples of charges for optional services were addressed, and in both cases the FRB declined to apply the principle that fees are finance charges even if for voluntary products or services. This time the rationale centered on the "incident to" phrase, more than whether the charges were "imposed."

c. Round 3: What is Next? DCAs Revisited?

In each of these post 1995 rulemakings, the FRB has been willing to back away from a blind application of its incurred-means-imposed principle, and applied separately the test that in any case a finance charge must be "incident to" an extension of credit. But it is doubtful the FRB means to retreat fully from the principle.

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[131] Commentary ¶ 6(b)-2.x. Further, the Supplementary Information emphasizes that "[t]he expedited payment service covered by the proposal is not a payment method established in advance as the *expected method* for making regular payments on the account." 68 Fed. Reg. at 16,186 (emphasis added). And the same explanatory material says that while expedited payment fees may be neither finance nor other charges, that is only "at this time." *Id.* Even at this time, one can nit-pick the new Commentary language to pieces: Suppose a customer has missed two monthly payments and requests an expedited payment to restore the account to good standing. If this is not a "single payment," it doesn't qualify as a "not 'other charge.'" But is it now an "other charge," or does it revert all the way back to "finance charge"?

[132] Commentary ¶ 6(b)-2.ix.

In connection with the 2003 Commentary revisions on expedited payments and card delivery, the FRB staff noted that commenters had suggested the FRB adopt a general rule for the treatment of credit card fees. Said the FRB staff:

> There is significant merit in reviewing this area to assess whether general principles can be articulated for determining the appropriate treatment of creditors' fees. Accordingly . . . the staff plans to recommend that the Board undertake such an assessment to determine if a general rule can be established consistent with the requirements of TILA.[133]

At this writing, there is no evidence of any progress on this effort. In the meantime, however, the FRB reaffirmed its general commitment to an "all-in" finance charge principle, or at least to the view that voluntarily incurred charges are presumptively finance charges. As part of its new Commentary revision proposals in late 2003, the FRB staff asked for information regarding new forms of debt cancellation, or debt suspension, agreements.[134] The FRB staff mentioned anecdotal information about new forms of debt cancellation or suspension agreements keyed to life cycle events such as marriage and divorce.[135] In the request, the FRB staff reminded that "although debt cancellation fees satisfy the definition of a 'finance charge'" and may be excluded only if properly disclosed, "[t]he types of debt cancellation agreements eligible for the exclusion"[136] are limited to certain forms of DCAs as specified in Regulation Z.

> [The exclusion of DCAs from the finance charge on proper disclosure] applies to fees paid for debt cancellation coverage that provides for cancellation of all or part of the debtor's liability for amounts exceeding the value of the collateral securing the obligation, or in the event of the loss

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[133] Commentary ¶ 6(b).

[134] 68 Fed. Reg. 68,793, 68,795 (Dec. 10, 2003).

[135] Caroline E. Meyer, *Lenders Peddle Protection at a Hefty Profit*, THE WASH. POST, Mar. 13, 2004, at E-1 (discussing how these products have drawn the attention of the popular press).

[136] 68 Fed. Reg. at 68,796.

of life, health, or income or in case of accident.[137]

Thus, says the FRB staff, DCAs are excluded from the finance charge only if they cover the same kinds of mishaps as credit insurance. At least presumptively, then, these new-fangled DCAs are finance charges unless and until the FRB rationalizes them out of that category.

The FRB may also have its eye on a potential collision between excludable credit insurance and DCA fees on one hand, and the separate and unqualified inclusion in the finance charge of pure, old-fashioned default insurance on the other.[138] If creditors offer wide-ranging forms of agreements that cover or reschedule the outstanding debt in a variety of circumstances that otherwise might trigger default, one can certainly ask whether those products have not become a form of "guarantee or insurance protecting the creditor against the consumer's default or other credit risk."[139] And for this type of creditor protection there is no easy escape from a finance charge characterization.[140] It is, after all, payment for one of the characteristics of credit arrangements—the allocation of risk.

To this point, the FRB staff has stuck to its theoretical guns on the proposition that charges incurred are charges imposed, and therefore finance charges. But they have not made that proposition stick to any of the examples brought before it. Meanwhile, the FRB staff's latest and rather casual pronouncement concerning life-cycle DCAs is an open invitation to consumers and their lawyers to litigate the proper disclosure of charges for those products. The mere restatement of the staff's theoretical position may create a prima facie case of mis-disclosure for creditors that are not treating those charges

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[137] Regulation Z § 226.4(d)(3)(ii) (emphasis added).

[138] *Id.* § 226.4(b)(5) includes in the finance charge, "Premiums or other charges for any guarantee or insurance protecting the creditor against the consumer's default or other credit loss." *Id.*

The Commentary to this subsection identifies "repossession insurance" as a form of credit loss insurance. Commentary ¶ 4(b)(5)-1. If a DCA forgives the loss resulting when the debtor is divorced and surrenders his financed automobile to the creditor because he is unable to maintain payments, is that really a DCA or is it "default or other credit loss" protection? If it is the former, it may be out of the finance charge; if the latter, it is in.

[139] Commentary ¶ 4(b)(5)-1.

[140] Unlike credit insurance and DCAs, there is no legal mechanism for excluding credit loss insurance from the finance charge, even if it is optional and disclosed as such.

as finance charges.

V. In Search of a Better Principle for Optional Charges

The questions still begging answers are whether the optional nature of the associated product or service, in and of itself, controls the characterization of the charge, and when and whether this product or service is so related to the credit extension as to be part of its cost. The question can be put simply: are charges for optional products or services "imposed" by the creditor, and are they "incident to the extension of credit," within the meaning of the regulatory definition? One possible answer is a flat "no," on the premise that the finance charge is meant to capture only those costs that the consumer must pay to get the agreed credit at the agreed rate and over the agreed term. Charges for additional services or products that the consumer can take or leave are, on this theory, not finance charges. An alternative answer, consistent with TILA's generally all-inclusive approach to measuring the cost of credit, is to say that once the consumer agrees to add an additional product or service to the credit agreement, the fee becomes an obligation of the consumer and to that extent is required—"imposed"—as an "incident" of the overall transaction or plan, unless, of course, it fits one of the explicit exclusions in Regulation Z. Notice that neither of these approaches looks at the amount of the fee or where the fee goes; whether the fee is marked up to generate revenue for the creditor, or is shared with third-parties who help provide the optional product or service, is disregarded.

The trouble with the first approach—the flat "no, optional charges are not finance charges"—is that it may be too sweeping in coverage, prone to abuse through high pressure or deceptive marketing, and it tends to dilute the finance charge and understate the APR whenever a creditor can shift its pricing strategy from mandatory charges to supposedly optional ones. The opposite all-in approach—anything the consumer agrees to pay is presumptively a finance charge—is also problematic, in exactly the opposite direction. It tends to inflate the finance charge (and APR) with additional fees that are not really credit-related, thus overstating credit costs and probably discouraging creditors from offering those auxiliary products and services. It also requires a series of ad hoc evaluations and reviews by the FRB when new fees surface, until their treatment is specifically addressed. Further, it violates the basic congressional conception of the finance charge as a measurement of the cost of credit, not the cost of something else.

The choice of approach becomes even cloudier when one considers subsidiary questions including:

> Should it make a difference whether the extra service is included in the plan at the outset or is added later?[141]
>
> Does it matter whether the extra service (and the fee for it) is included in the documentation for the "plan," or is a free-standing agreement?[142]
>
> Does it make a difference to whom the charge is payable—the creditor itself, or a third-party service provider?[143] If a third party provider is involved, does it matter whether the creditor keeps or otherwise shares part of the fee?[144]
>
> Does it matter how often the consumer uses the optional service?[145] Could the service and the fee become de facto

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[141] In the recent ruling on expedited services, the Board staff itself waffled on this aspect. Fees for expediting payments are "not 'other charges'" only if they are *not* part of the original agreement, but a fee for expedited card delivery qualifies as a "not 'other charge'" even if incurred when first opening the account. *Compare* Commentary ¶ 6(b)-2.x *with* Commentary ¶ 6(b)-2.ix.

[142] Or suppose the charge for expedited payment service that the creditor advertises or promotes is institution-wide (not limited to borrowers), and is available to any customer who wants to transfer funds, whether to pay a credit card bill, make a deposit, purchase a CD, or whatever. Is the fee still "incident" to the plan?

[143] *E.g.*, the courier company that delivers the expedited card, or the vendor who arranges the expedited ACH payment. Regulation Z § 226.4(a)(1)(i) cryptically sweeps some third-party charges into the finance charge if the creditor "requires the use of a third party as a condition to the extension of credit." *Id.* But this does not apply if the fee is "otherwise excluded under this section," which makes the rule a bit circular with respect to fees for services offered by the creditor on an optional basis but to be performed by a third party.

[144] Third-party charges are also finance charges if the creditor "retains a portion of the third-party charge, to the extent of the portion retained." Regulation Z § 226.4(a)(1)(ii). But this too is qualified: "unless [the fee is] otherwise excluded under this section." There is the same circularity here as noted in the preceding footnote.

[145] The recent rulemaking on expedited payments is curious in this regard. It explicitly says that to qualify for the "not 'other charge'" category, the service fee must relate to "a single payment on the credit account" and cannot be "a payment method established in advance as the expected method for making regular

part of the plan just by repetition?

These questions, and others that will arise, may be answerable, but they suggest that any clarifying principle dealing with optional fees will need to be both nuanced and clear.

VI. Other (Im)possible Approaches to Optional Services Fees: Finance Charge or Not?

There may be several other theoretical approaches to identifying whether, and when, charges for optional services are finance charges. The trouble is, most of them do not work very well when push comes to shove.

A. The Truly "All-in" Finance Charge

The TILA finance charge definition began as a rather all-inclusive one, and then has been whittled away by statutory and regulatory exceptions over time. Why not strengthen the all-in premise of the finance charge definition by drawing a line that permits no further exceptions, and perhaps revisits some current ones, from the literal language "imposed . . . incident to" an extension of credit?

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payments on the account." Commentary ¶ 6(b)-2.x; Supplementary Information, 68 Fed. Reg. at 16,816. Yet the Commentary expressly says that the exclusion operates "regardless of how frequently the consumer requests the service." So apparently a consumer could request expedited payment services every single month, so long as the underlying plan permitted payment by regular mail as a matter of contract right. (One can imagine the bold graphic on every periodic statement: "Avoid late charges. For expedited payment, call 1-800-123-4567.") If this is permitted, why shouldn't the consumer and the creditor be able to agree at the outset to use the expedited service without a monthly ritual of separate requests? Suppose the original credit agreement doesn't specify any "expected" method of payment, but gives the consumer choices: pay by mail, by debit to your checking account, or by ACH transfer from an account elsewhere. Now how do you characterize fees related to these choices? The Board's supplementary information concerning the Commentary on expedited payment says that it

> [W]as not intended to address electronic payment options that are not offered as an alternative to paying a late fee, or bill payment services offered in connection with a consumer's deposit account that might be used to pay credit card bills as well as other bills.

68 Fed. Reg. at 16,186.

Apparently, therefore, a fee for an optional electronic payment option is subject to the general rules on finance charges, and would appear to be "imposed" (*i.e.* incurred) as an "incident to" the credit extension.

The FRB, in fact, moved in this direction in its 1998 Report to Congress ("FRB-HUD report") with the Department of Housing and Development ("HUD") on reforming TILA and the Real Estate Settlement Procedures Act ("RESPA") with respect to mortgage transactions,[146] recommending several variations of a more or less "all-in" finance charge definition. The FRB even suggested new statutory language to help achieve this goal. The essential definition of finance charge would be "the cost the consumer is required to pay to get the credit," and this would include numerous consumer outlays that are now excluded from the finance charge.[147] Whether the proposed language would foreclose debate about charges for optional services is doubtful: the phrase "required to pay" seems as potentially ambiguous as the current "imposed . . . incident to" language. The theory would be that once the consumer elects the optional service and incurs the fee, that fee becomes an additional cost to the consumer for the now-modified credit plan.

The FRB-HUD Report primarily addressed closed-end mortgage loans, so one should not over-read the "all-in" proposal. But, conceptually, it could be extended to all forms of credit, including open-end plans, and, if so, there are problems with it at several levels.[148] An all-in approach would tend to inflate the amounts of finance charge and resulting APR, particularly the historical APR in open-end periodic statements.[149] While some might cheer this effect because it would force creditors to compete on the basis of rate (APR) as well as customer service, this treatment of optional fees in open-end credit would not really affect the nominal APR—the prospective, annualized periodic rate—at all. And it is only that nominal rate that the creditor must disclose in advertising, solicitations, and account-opening disclosures.[150] The fee-based exaggeration of the historical APR could at best influence those

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[146] Board of Governors of the Federal Reserve System & Department of Housing and Urban Development, JOINT REPORT TO THE CONGRESS CONCERNING REFORM TO THE TRUTH IN LENDING ACT AND THE REAL ESTATE SETTLEMENT PROCEDURES ACT, Ch. 2 (July 1998) [hereinafter *FRB-HUD Report*].

[147] Most of the real estate exclusions in present law would be eliminated, and in one of the suggested variations (the "consumer pay" approach) even optional charges such as for credit life insurance would be included. *Id.* This would require significant statutory amendments to accomplish.

[148] *See FRB-HUD Report*, *supra* note 146.

[149] *See supra* text accompanying notes 25-31.

[150] Regulation Z §§ 226.5a(b)(1), 226.6(a)(2), 226.16(b)(2).

current cardholders who saw and understood the historical APR.[151]

The more serious objection to the all-in approach is that, at least in many applications, it has no economic integrity. Take the two most recent examples, expedited payments and expedited card delivery. The customer's contractual account relationship with the creditor—the credit line, rate and other contingent costs, and payment obligation—remains unchanged whether a customer elects the optional service or not. The customer may avoid a late charge by requesting an expedited payment, or enjoy uninterrupted access to the credit by getting courier delivery of a new card. Those extra fees are not only optional, they are not costs attributable to the establishment or maintenance of the credit.[152] The fee buys an independent, palpable benefit to the consumer, distinct from or at most peripheral to the credit product itself.

B. "Follow the Money"

A superficially attractive way to deal with charges for optional products or services might be to focus on the creditor's net yield as the measure of a finance charge. For example, if it costs the creditor eight dollars to arrange the expedited delivery of a customer

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[151] *See supra* text accompanying notes 27-32 (explaining that APR is still subject to many difficulties).

[152] Other hypotheticals suggest gradations of the issue:

> (1) A card-issuing bank promotes the availability, for a five dollar fee, of an end-of-year compilation of credit purchases and cash advances, to help the customer with record-keeping and tax preparation. That fee may be literally "incident" to the credit plan, but it is for a discrete data service that is in no sense a cost of the credit.
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> (2) A card-issuing bank promotes to cardholders the availability of a safe-deposit box service for five dollars per month, chargeable to the card account. That bank service and fee may tenuously be "incident" to the plan, but the deposit-box service has nothing to do with the credit and the fee is not a cost of that credit.
>
> (3) A cardholder responds to a "stuffer" advertisement in her periodic statement and orders a fifty-dollar toaster which is charged to her account. The toaster solicitation is piggy-backed on the open-end plan periodic statement, and the purchase will be shown on a subsequent statement, but it strains credulity to suggest that an all-in principle should treat the fifty dollar toaster as a finance charge.
>
> (4) A customer must buy a postage stamp to mail in a payment; or must buy a computer or pay phone charges to make an electronic payment. Are these "incidental" finance charges?

payment through an ACH, and the creditor charges the customer fifteen dollars for that service, the seven dollar mark-up or profit would be treated as a finance charge. The premise of this approach is that while eight dollars of the customer's expenditure buys equivalent value, the remaining seven dollars goes directly into the creditor's hopper of earnings from the credit plan and is therefore part of the cost of the credit—a finance charge.

As a general proposition, TILA does not attempt to restrict the amount of creditor charges, or to differentiate between the cost and profit portions of those charges. TILA tries to make the credit pricing transparent, through disclosure, but does not limit rates or other price components. With respect to optional services, the best example is credit insurance, where the premium is excluded from the finance charge if voluntary and properly disclosed, even though the creditor realizes substantial profit from the sale of the insurance, through rebates, commissions, or similar arrangements with the insurance underwriter. The treatment of casualty insurance on property serving as collateral is comparable.[153] Another example may be non-filing insurance, which is excluded from the finance charge so long as the premium does not exceed the actual costs of filing financing statements to perfect security interests; the regulation ignores any profit margin the creditor can realize within that cap.[154] And clearly amounts excluded from the finance charge because they are payable in comparable cash transactions, such as extended warranties, remain excluded even though they include substantial price mark-ups.[155]

Still, the approach of treating as finance charges only portions of consumer cost components—"following the money"—is not unprecedented in TILA finance charge jurisprudence. Since 1968, the Act and Regulation have permitted real estate creditors to exclude

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[153] Regulation Z § 226.4(d)(2) (providing that a consumer may opt to obtain casualty coverage on his own, but if the insurance is obtained from or through the creditor the creditor must disclose the term and premium).

[154] Courts have clamped down on "padded" non-file insurance. *Cf.* Edwards v. Your Credit, Inc., 148 F.3d 427 (5th Cir. 1998) (confirming findings that the non-filing insurance was essentially spurious).

[155] This can create other disclosure problems, however. There has been significant litigation on the creditor's disclosure of payments to third parties as part of the itemization of the amount financed where the creditor has "upcharged" the third party's price to generate profits for itself. Regulation Z § 226.18(c). The leading case holds that a creditor is apparently safe from litigation only if it discloses the actual splits or at least discloses that "we may be retaining a portion of this [third-party payment] amount." Gibson v. Bob Watson Chevrolet-Geo, Inc., 112 F. 3d 283, 285 (7th Cir. 1997).

from the finance charge a variety of mortgage-loan closing costs.[156] But the regulation adds the qualification that the fees must be "bona fide and reasonable in amount," presumably to discourage creditors from packing or inflating these charges. The effect, then, is that a charge that is not bona fide, or that exceeds a reasonable amount is a finance charge, at least to the extent of the excess. The same issue can arise in connection with the finance charge tolerances that permit some understatement without it constituting a TILA violation.[157]

"Follow the money" shows up in several other places as well. These involve third-party charges that would normally not be finance charges because the creditor does not impose them. But "if the creditor . . . retains a portion of the third-party charge," it is a finance charge "to the extent of the portion retained."[158] Another example involves taxes and fees for creating or releasing a security interest, where the exclusion extends only to charges "prescribed by law that actually are or will be paid to public officials";[159] the intimation is that a mark-up of governmental fees is a finance charge.[160]

These examples of a "follow the money" approach apply most often to mortgage loans, where there has been long-standing concern about the packing of closing costs. But the regulatory language could extend, or be extended, to some optional charges relating to credit cards or other open-end credit offerings. In the example above where the creditor charges fifteen dollars for arranging an expedited payment, pays eight dollars to a third-party "expediter," and pockets the extra seven dollars for itself, one might argue that the seven dollars should be a finance charge.[161] This could be applied to any

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[156] Truth in Lending Act § 106(e), 15 U.S.C. § 1605(e) (2004); Regulation Z § 226.4(c)(7).

[157] Regulation Z §§ 226.18(d), 226.23(g). There has been a recent flurry of litigation on these issues, including the following question: If the charge is more than a reasonable amount, does the whole charge become a finance charge, or only the excess? *See, e.g.*, Guise v. BWM Mortgage LLC, 377 F.3d 795 (7th Cir. 2004). *See also* Craig A. Varga, *Turn Back the Clock of Tolerance in TILA Mortgage Cases?*, CONSUMER FIN. SERVICES. LAW REP., vol. 7, No. 16, at 3 (Feb. 25, 2004) (reporting on pending cases challenging fees as outside of tolerances).

[158] Regulation Z §§ 226.4(a)(1)(ii), 226.4(a)(2)(iii).

[159] *Id.* § 226.4(e)(1).

[160] *Compare* Abbey v. Columbus Dodge, Inc., 607 F.2d 85 (5th Cir. 1979) (finding mark-up was a finance charge), *with In re* Fryer, 183 B.R. 322, *motion for recon. denied*, 183 B.R. 654 (Bankr. S.D. Ga. 1995) (finding mark-up was not a finance charge).

[161] The current language on third-party charges probably does not fit here

optional services that involve a third-party vendor.

The problem with this approach is partly theoretical and partly practical. At the theoretical level, it ducks the core question whether it involves the cost of credit, i.e., whether the optional service fee is "imposed . . . incident to an extension of credit," the essential finance charge definition. If the creditor is providing a truly optional service that is fairly disclosed and only tangential to the underlying credit plan, why should any part of that charge be considered a finance charge? This approach would tag certain creditor revenue streams as finance charges without regard to whether the charge was really for one of the four cost-of-credit components: origination, servicing, funding, and risk of loss.

An even bigger problem is the practical one. How, and when, does one measure the amount of retained revenue—the supposed profit—that the creditor realizes from these optional services and that this approach would treat as finance charge? Again, in the example above, it was assumed that the fifteen dollars expedited payment charge is split between the creditor, who gets seven dollars, and the third-party expediter, who gets eight dollars. But is not the creditor entitled to some compensation for overhead in handling the arrangement, and if so, how much? Suppose the working compensation arrangement with the expediter is that the division of revenues depends on volume, or is otherwise set after the fact on an experience or commission basis; here there is no way to know at the time the customer chooses the service how the fifteen dollars will be divided.[162] Suppose the creditor supplies the service in house, without using third parties at all? Is it necessary to analyze the creditor's operating expenses? Suppose the optional service was mis-priced, or designed as a loss leader, and didn't really generate any profit revenue? Whatever supposed attractiveness there is in trying to isolate components of creditor fees as finance charges, it almost certainly fails in the execution. At best, it would leave the rule murky, without the kind of bright line reliability that creditors desire and the public should expect of a disclosure law.

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because the creditor does not "retain" a portion of an amount "charged" by the third-party. Regulation Z § 226.4(a)(1)(ii).

[162] Conceivably the creditor could disclose an "estimated" finance charge amount, but that just compounds the uncertainty and artificiality of trying to follow the money. Regulation Z §§ 226.5(c), 226.17(c)(2).

C. Emphasize the "Optional" Nature of the Charges

A third alternative approach would build on the premise that fees for truly optional products or services cannot be finance charges so long as there is a baseline credit plan the consumer can use without those products or services. A rough analogy might be drawn to the purchase of a new car. The buyer's objective is reliable transportation, and the buyer can choose the stripped-down version of a new vehicle to achieve that objective. But, for various reasons, the buyer may want accessories like a DVD player, a navigation or security system, or a full-size spare tire. Or the buyer might want distinct add-ons, like a trailer hitch or an auto club membership, and these and other add-ons may be available at the time of sale or afterward. In the buyer's calculus of what to spend, "basic transportation" has one price, while personal preference adds additional costs. A credit plan might be viewed in a similar way—a basic plan and an enhanced plan.

Theoretically, pursuing this approach means accepting the notion that the finance charge includes only those costs the consumer is required to pay to obtain the baseline credit plan. Any other optional add-ons are just that, separate items or features, freely chosen, for a price reasonably disclosed and therefore comparable to other creditors' offerings. However rational such an approach might seem, it is fraught with difficulties.

It is contrary to the expressed view of the FRB staff that even optional charges are finance charges, and would require the Board's reassessment and redirection of that view, perhaps by regulatory or statutory fiat.

It would likely accelerate the pace, and perhaps open the floodgates, for creditors to shift pricing from basic credit costs, like the interest rate, points, or APR, to optional add-ons, to the extent that the finance charge and APR would become less significant, even unreliable, measures of the realistic cost of credit.

It is overly simplistic in treating all optional products or services alike. Even though in recent rulemakings the Board as a practical matter has not actually treated an optional fee as a finance charge, there are some candidates for such treatment. For example, in connection with the regulatory revision to deal with DCAs, the Board itself posed the example of a variable-rate loan where the customer, for a fee, could add an option to convert to a fixed-rate loan.[163] The Board reasoned:

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[163] 61 Fed. Reg. 49,237, 49,239 (Sept. 19, 1996).

> Even though the lender does not require that particular feature, when it is included for an additional charge (either paid separately at closing or paid in the form of a higher interest rate [or points]), that amount properly represents part of the finance charge for that loan, even though less costly loans may be available without that feature.[164]

This seems intuitively correct. The same could be said, for example, for a charge to permit the consumer to make bi-weekly payments instead of monthly, or a charge to permit the consumer to skip payments over the winter holidays or in the summer months. The point is that these optional features change the basic credit relationship by altering the contractual repayment pattern under the loan. And if the press reports on new forms of life-cycle DCAs are accurate,[165] these, too, may be voluntary options, but ones that alter the basic performance obligations and risk allocations in the credit extension.

This "optional means out" approach would also almost certainly resurrect the debate over reverse competition and high-pressure or deceptive marketing that permeated discussions of voluntary credit insurance. Creditors might pay lip service to whatever ground rules are in place to assure that optional products and services appear voluntary, but still engage in sharp selling that achieves substantial penetration rates in terms of percentages of consumers led to choose the optional feature.[166]

To respond to the marketing concern just described, it would almost certainly be necessary to build into the TILA structure some explicit mechanism to try to assure real voluntariness on the part of consumers. That would likely mean something like the current rules for credit insurance and DCAs—disclosure that the feature is not required, its cost if chosen, and a separate signed authorization from

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[164] *Id.* at 49,239.

[165] *See, e.g.*, Meyer, *supra* note 135, at E-1 (discussing the impact of the rapid unregulated increase in debt protection programs on consumers).

[166] In fact, it could be worse. Credit insurance products at least are regulated as insurance, for example as to loss ratios—the percent of premiums paid out in claims. The various other examples of optional features have no independent regulatory framework, and to the extent a creditor's offerings are unique to it, there is no competition at all. *See* Meyer, *supra* note 135 (reporting one estimate that loss ratios on life-cycle DCAs were in the low single digit range, as compared to fifty to sixty percent for regulated credit life or disability insurance).

the consumer.[167] This could introduce new complexities as to the format, timing, and accuracy of those disclosures, and create a breeding ground for litigation.

D. A Remaining Conundrum: "Other Charges" or Not?

Regardless what approach is taken on optional charges as finance charges—one of the alternatives above, or the recommended one proposed below—there will remain the question whether certain non-finance charges are "other charges" in open-end credit. This has the consequences of requiring disclosure, and, in most cases, triggering change-in-terms notices if they are "other charges," but excluding them altogether from TILA coverage if they are "not 'other charges.'"

The current test for "other charges" is that they are not finance charges, are "significant," and are "related to" the plan.[168] The question is whether this provides adequate, consistent guidance. The FRB's recent handling of expedited payment fees shows how shadowy the test can be. After acknowledging the views of commenters that an expedited payment charge "is not part of the credit plan and is not significant in its occurrence or in amount,"[169] the FRB merely stated its conclusion that "[b]ased on the record established by the comment letters, the fee for expediting a payment . . . does not clearly meet the standard for treatment as an 'other charge.'"[170] This was a grudging concession at best,[171] without shedding much light on the critical criteria of whether the charge was "significant" or "related to" the plan.

The FRB implicitly recognized that "significant" can refer both to the amount of the charge and to the frequency of its application. Recurring charges seem more obviously to call for disclosure than isolated or infrequent ones. Significance as to amount will probably remain elusive as a general criterion, except as it can be assessed for a particular charge. In the expedited payment charge

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[167] Regulation Z § 226.4(d). At the very least it would seem to require a specific disclosure of the costs of the feature, as is the present rule for excluding security interest charges from the finance charge. *Id.* § 226.4 (e).

[168] Regulation Z § 226.6(b)-1.

[169] 68 Fed. Reg. 16,185, 16,186 (Apr. 3, 2003).

[170] *Id.*

[171] Whatever the basis for the Board's conclusion, it is only operative "at this time," apparently reserving the Board's right to change its mind. *Id.*

analysis, the FRB noted that the fee was probably less than the amount of the late charge that it allowed the customer to avoid.[172]

A better opportunity for consistency rests, we believe, on the "related to" criterion. As the Commentary currently reads, it is a bit of a non-sequitur. It speaks of "charges related to the plan,"[173] when conceptually the issue really is whether the product or service purchased for that fee is functionally related to the plan.[174] The concept of "related to" must also be somehow different from the notion of "incident to" which drives the finance charge definition. From this perspective it may be easier to judge whether certain charges are "other charges" to be disclosed as such. If the charge is for a service that affects the plan but does not change the creditor's or the consumer's rights or obligations under the plan, it is an "other charge." If the charge is for an unrelated or accessory service that merely results in the posting of the charge to the account, it is not an "other charge." Thus a fee for credit fraud insurance, or for providing hard-copy periodic statements, would be "other charges," but a fee for use of an institution-wide customer hotline, or for safe-deposit box privileges, would not.

It may also be defensible to say flatly that any fee that is not a finance charge and is truly optional on the consumer's part is not an "other charge" either. Whether this works may depend on which approach to the finance charge definition is in place. If the finance charge includes optional charges that are considered "imposed . . . incident to" the credit transaction, there is more justification for releasing non-finance charge fees for optional add-on products or services from any disclosure burden. Even "not 'other charges'" are presumably based on a contractual agreement between the parties, and will show up as an entry on the periodic statement.

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[172] *Id.*

[173] Commentary ¶ 6(b)-1.

[174] Conceivably, the consumer could agree to pay for a particular plan-related service in cash. It makes no sense to ask whether this *payment* of a charge is incident to the credit plan. Rather, one needs to know what service the charge is for, and how that service relates to the plan.

VII. A Recommendation for a Finance Charge Principle for Optional Products or Services

A. Implicit Policy Restraints

From the discussion to this point it is possible to state several baseline policy issues relating to fees for optional products or services.

1. Non-Interference with Product Design

From the beginning of TILA in 1968, the basic premise of the Act has been that creditors must accurately disclose their credit charges and terms, but are free to design and price their credit offerings as they wish. TILA is neither a usury law, nor a prescriptive limitation of contract terms.[175] The characterization of charges as finance charges, "other charges," or "not 'other charges,'" therefore, should be approached carefully so that the disclosure consequences do not become de facto limitations on creditor ingenuity and consumer choice in the marketplace.

2. Integrity of the TILA Disclosure Scheme

The reliability of TILA to produce consumer disclosures that are truly comparable and consistent depends ultimately on the integrity of the finance charge definition and its applications. The TILA approach to the finance charge is generally an all-inclusive one, though replete with exceptions and carve-outs,[176] that emphasizes consumer outlays rather than creditor yield. This ought to require a reasonably meticulous test that sweeps into the finance

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[175] Of course TILA does *some* of this. There are a number of special credit card rules to regulate dispute handling and other processes involving credit card plans. *See, e.g.*, Regulation Z §§ 226.11, 226.12, 226.13. The TILA rescission rules permit consumers unilaterally to cancel certain mortgage loans. *Id.* §§ 226.15, 226.23. Some argue that the restrictive provisions of section 226.32, which implements the Home Ownership and Equity Protection Act ("HOEPA") of 1994, have the effect of capping rates and fees at the HOEPA thresholds for creditors who are reluctant to make subprime loans under the HOEPA restraints. Regulation Z § 226.32.

[176] The FRB itself refers to the current definition of finance charge as a "some fees in, some fees out" structure. *See, e.g.*, *FRB-HUD Report*, *supra* note 146, at VIII.

charge all sums the consumer pays "as an incident to or condition of" the extension of credit. To the extent creditors can shift revenue from "interest" or other obvious finance charge categories into non-finance charge fees, the finance charge becomes less reliable as a measure of the cost of credit.

3. Avoiding Disclosure Distortions

It is not good public policy in a law intended to foster "truth in lending" to use as a measure of the benchmark cost of credit a formula that distorts the finance charge number and the APR derived from it. Under-inclusiveness in the finance charge definition results in understated amounts of finance charge and correspondingly understated APRs. But over-inclusiveness is also undesirable when the finance charge sweeps in consumer outlays that really are not integral to the amount or availability of the credit, and therefore produces artificially skewed finance charge and APR numbers. The definition of finance charge ought to rest on an economically sound assessment of what is the real cost of the credit.

4. Unlikelihood of Statutory Change

The definition of finance charge has been essentially unchanged since TILA was first enacted in 1968. In the TILA "simplification" legislation in 1980, Congress and the FRB had an opportunity to revamp the definition, but they did not. More recently, in 1995, Congress instructed the FRB and HUD to review the content and timing of TILA and RESPA disclosures made in conjunction with mortgage loans. The agencies in fact recommended "that the definition of the finance charge . . . be expanded to include all costs the consumer is required to pay in order to close the loan, with limited exceptions."[177] There has been no serious congressional attention given to this recommendation since it was made in 1998. Call it inertia, or fear of the unknown, but there is probably little interest from any quarter in a radical reformation of the finance charge definition.[178] That means that any clarification of the

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[177] *FRB-HUD Report*, *supra* note 146, at III.

[178] The *FRB-HUD Report*, *supra* note 146, may be the most radical proposal concerning the finance charge in several decades, albeit directed primarily at mortgage credit. It not only would make the finance charge more all-inclusive than the present "some fees in, some fees out" approach, but would rewrite the basic mantra to state that the finance charge comprises "the costs the consumer is

treatment of fees for optional products or services will have to come within the constraints of language of the present statute, and probably, as a practical matter, without substantial change to Regulation Z.

B. The Current Predicament

In the present state of affairs, the issue of whether, and when, charges for optional products or services are finance charges is unsettled. The FRB maintains the policy that even optional charges are finance charges when they are "imposed"—meaning incurred by the consumer—as "incident to" the extension of credit, even though they are not required conditions for that credit. This posture by the FRB has led to several rulemakings where the FRB has retreated from applying its policy strictly, suggesting that even the FRB realizes that its approach is somewhat overbroad and uncertain. In the meantime, as optional services and fees for them proliferate in the marketplace, creditors, consumers, and regulators lack guidance on the proper treatment of those charges. Creditors in particular face litigation exposure, which is reinforced when the FRB staff pronounces and re-pronounces its general policy with respect to products and services that are not yet the subject of formal rulemakings.[179] Not only has the FRB put creditors at risk, but the process for clarifying whether particular optional charges are or are not finance charges remains wholly reactive where the FRB staff takes up one example at a time. There must be a better way.

Coincidentally, the Supreme Court in its recent decision in Household Credit Services, Inc. v. Pfennig[180] may have provided an interpretational hint that both confirms the difficulty of the TILA line drawing and acknowledges the need for it. The issue in the case was whether an over-limit fee imposed by a card issuer was properly treated under Regulation Z and the Commentary as an "other charge"

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required to pay to get the credit." While the Report says this would "eliminate most of the difficulties," *id.* at IX, one can foresee another thirty years of interpretive uncertainty over this choice of words. Even under its recommendation, the Report carefully notes, "[f]ees for optional services and costs that depend on consumer choices . . . would continue to be excluded." *Id.* at IX n.18.

[179] The Board recently published its view that charges for new forms of life-cycle debt suspension agreements are at least presumptively finance charges. But this was in the context of an informal request for information about those products, and the request itself was tacked on to formal proposals for Commentary revisions on completely different topics. 68 Fed. Reg. 68793, 68795 (Dec. 10, 2003).

[180] Household Credit Serv., Inc. v. Pfennig, 124 S. Ct. 1741 (2004).

rather than as a finance charge. The cardholder argued below that since the fee was triggered by an extension of credit beyond the established limit, it was literally a cost of new credit and, therefore, a finance charge and the Court of Appeals agreed.[181] The Supreme Court, however, criticized the court below because it "made no attempt to clarify the scope of the critical term 'incident to the extension of credit.'"[182] Continuing, the Court said:

> Certainly, regardless of how the fee is characterized, there is some connection between the over-limit fee and an extension of credit. But, this Court has recognized that the phrase "incident to or in conjunction with" implies some necessary connection between the antecedent and its object, although it "does not place beyond rational debate the nature or extent of the required connection. . ." [citation omitted]. In other words, the phrase "incident to" does not make clear whether a substantial (as opposed to a remote) connection is required. Thus, unlike the Court of Appeals, we cannot conclude that the term "finance charge" unambiguously includes over-limit fees. That term, standing alone, is ambiguous.[183]

We believe the issue as to charges for optional products or services is exactly so. Whether they are finance charges may be subject to "rational debate," but is ultimately to be determined by how substantial or remote is the connection between the service purchased with the fee and the underlying credit arrangement.

C. Proposal

Especially in light of the *Pfennig* insight, we despair of drafting a rule on optional service charges that is at once comprehensive (to cover all imaginable fees), crystal clear (to provide bright line safe harbors), and consonant with long-standing TILA disclosure policies (neither under- nor over-disclosure). But we do believe it is possible to state a general principle that is consistent with both economic and legal understandings of the cost of credit. Creditors would then need to make business and legal judgments about how the principle applied to the particular charge at hand. The

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[181] Pfennig v. Household Credit Serv., Inc., 295 F.3d 522, 534 (6th Cir. 2002).

[182] *Pfennig*, 124 S. Ct. at 1748-49.

[183] *Id.*

existence of the principle as an exercise of FRB interpretational authority for TILA should provide a measure of protection for creditors against litigation challenges or bank examiner criticism. Yet the FRB, and the courts, would remain free to analyze whether, in a particular instance, the creditor had properly characterized the charge.

The principle might be stated as follows:

> Some charges that consumer borrowers pay for optional products or services are either not imposed by the creditor, or are not incident to an extension of credit. In general, a fee incurred by a consumer for an optional product or service offered by or through the creditor is not a finance charge if
>
> > (a) The fee is designated for a product or service that is voluntarily purchased by the consumer pursuant to an agreement that is severable from or additional to an underlying credit transaction or plan;
> >
> > (b) The creditor discloses the fee for the product or service to the consumer in a reasonable manner before or at the time the consumer agrees to incur the charge; and
> >
> > (c) The consumer's purchase, or failure to purchase, the product or service does not alter the amount of the credit, the consumer's access to it, the timing or method of repayment, or the allocation of credit risk, as provided in the underlying transaction or plan.

Some explanations on this formulation:

The preamble is meant to confirm the general proposition that while some optional fees may be finance charges, some such fees are not. This is generally consistent with the current FRB view. It rejects the notion that merely because a product or service is optional, the charge for it cannot be a finance charge.

To fit under this exclusionary principle, the product or service must satisfy all three of the criteria in subsections (a) through (c).

Subsection (a) emphasizes the voluntariness of the purchase, as a distinct option or add-on to what is otherwise a complete transaction or plan. Creditors will need to be prepared to demonstrate and defend the contractual independence of the optional product or service, but this language does not prescribe any particular method

for doing so.[184] This criterion could include optional add-ons at the time the transaction is consummated or the open-end plan is established, as well as optional after-market add-ons.

Subsection (b) contemplates that the optional product or service, and the charge for it, must be disclosed before the consumer commits. It does not specify the language or format of the disclosure, only that it be in a reasonable manner, which could be oral. Again, the creditor would have the burden of demonstrating that it made an appropriate disclosure. Nothing in this proposed principle limits the amount of the charge or the manner in which the creditor may share it with third parties.

Subsection (c) zeroes in on the essential cost-of-credit aspect. Whatever the optional product or service, the consumer's action or inaction with regard to it must leave the underlying credit relationship intact. If the optional product or service changes any of the original credit terms or adjusts the credit risk, the fee is not excluded under this principle. These essential credit terms include the amount of credit or credit line, the timing of the availability of funds or the consumer's means of accessing a credit line, the schedule of payments (including minimum payments in an open-end plan), and the medium through which payments are made.

We believe this principle is consistent in fact with the specific rulings of the FRB since 1995.[185] As a general proposition, DCAs would be kept within the finance charge category under this principle because they do not satisfy criterion (c): by purchasing the DCA, the consumer's repayment obligation is modified to permit certain payments to be excused or deferred.[186] Charges for expedited payments, at least isolated payments, would fit this exclusionary principle, because the underlying terms of the credit plan remain unchanged whether the customer uses the expedited payment service or not.[187]

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[184] One can imagine that creditors might devise an "agreement" mechanism similar to that used now for credit insurance and DCAs—a separately signed authorization.

[185] It is also consistent with the earlier, pre-1980, staff letters on optional purchases. *See supra* text accompanying notes 85-88.

[186] Of course the Board has gone farther and permits creditors to exclude certain DCA charges from the finance charge on proper disclosure and with explicit customer authorization, in parallel with the statutory and regulatory provisions on credit insurance. Nothing in this suggested principle would inhibit the Board from making similar adjustments for other types of optional charges.

[187] While it is true that by declining the expedited payment service the

Applied to other examples mentioned in this article, the suggested principle produces, we believe, the right results. None of the four hypotheticals, *supra* note 138, would be finance charges because the purchased item or service has no bearing on the underlying credit repayment or risk allocation. Most of the examples in the text following note 16, *supra*, also would appear not to be finance charges, since there is no adjustment of credit terms or risk. The FRB's own example of a fee for the right to convert an adjustable rate to a fixed rate would seem clearly a finance charge, as it affects the creditor's yield and risk.[188] The charge for new cash-advance checks might seem to be a finance charge under our suggested principle (because it affects the consumer's access to the credit line), but the charge is probably excluded so long as it does not exceed the cost of replacement checks for a deposit account.[189] The "subordination fee," *supra* note 13, is probably a finance charge because the refinancing creditor requires the subordination.[190]

As conceded, not all examples would be so easy. More difficult would be a creditor fee for arranging electronic payments on an open-end account, either as an add-on arrangement after the plan has been established, or as an optional arrangement at the plan's inception. To be excluded from the finance charge under the FRB's existing 2003 Commentary clarification concerning expedited payments, the optional "expedited" payment fee must relate to a single payment and the plan must permit a baseline payment method that involves no fee. At first blush, under the suggested principle, this seems unduly narrow. Arranging regular ACH payments from a consumer's deposit account, in lieu of payments by regular mail, does not measurably change the credit risk; if the consumer closes the deposit account, or maintains a balance too low to cover the prearranged debits, the creditor still faces a delinquency and a collection risk. Moreover, for the consumer, the electronic debit fee replaces a postage stamp and the time the consumer uses to write and mail a paper payment, and no one argues that the cost of the stamp is a finance charge. On the other hand, if the consumer voluntarily agrees to electronic payments each month, there is less risk that a

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consumer may incur a late charge, which the expedited payment service would avoid, the imposition of that late charge is not a change in the terms of the plan but merely an application of one of them.

[188] *See supra* notes 163-64.

[189] Regulation Z § 226.4(b)(2); Commentary ¶ 4(b)(2)-1.

[190] Regulation Z § 226.4(a)(1)(i).

payment will be overlooked or paid late. Also, electronic payments are likely to reduce the creditor's servicing costs by eliminating labor-intensive paper check processing. On balance, we believe that a creditor fee for ACH or similar handling of payments on a recurring basis sufficiently reflects a component of credit costs (account servicing) that it should be considered a finance charge.[191]

Many real or theoretical optional charges would fall out of the finance charge because they simply do not implicate the credit relationship, and are merely accessories to it. On the other hand, a charge for an option to convert an adjustable to a fixed-rate obligation would be a finance charge because the consumer's repayment obligation and price have been changed. So would a fee for a skip-payment option, for the same reason. Indeed the generic class of optional service charges that would most often be treated as finance charges are debt cancellation or debt suspension agreements—or whatever the creditor calls them—where, for a fee, the creditor agrees to reduce or suspend the customer's payment obligation. In this kind of arrangement, the creditor and consumer are bargaining for a basic reallocation of credit risk and a modified revenue stream. A premium charge for that sort of reallocation is, we submit, part of the essence of the cost of credit.

D. Methodology of Implementation

If a version of this principle is worth implementing, there is a question of how to do it with the least disruption of the long-standing

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[191] Under the Electronic Fund Transfer Act, creditors may not *require* that consumers make payments electronically. Electronic Fund Transfer Act § 913(1), 15 U.S.C.A. § 1693k(1) (2004). But if a creditor were free to require electronic payments, it would seem clear that a fee for that arrangement would be a finance charge—"imposed as an incident to" the credit extension. If a consumer voluntarily chooses to make electronic payments, and becomes contractually bound to do so, the fee for that service is no less a cost of the credit package.

A creditor theoretically could offer a credit product such as a credit card as a loss leader, expecting to make counter-balancing revenue from the sale of optional products or services that are marketed to cardholders. For example, the card might carry a below-market APR and no other significant fees, but the issuer might market travel services, investment products—even toasters, at a substantial profit. The principle we suggest here simply would not reach this situation. The associated products or services have only the most remote relationship to credit extension, and ought not seriously be considered to be finance charges. Something comparable occurs when the auto manufacturers subsidize the rates charged by their captive finance companies, allowing the lawful marketing of "zero percent" or other minuscule APRs.

statutory and regulatory provisions.

Although most of the discussion in this article has involved open-end credit, the finance charge definition is universal, applying to closed-end credit as well as open-end credit.[192] There is nothing about the proposed principle that limits its applicability to one form of credit or the other. So the "principle" should be stated with equal applicability to both. That suggests it be related to the basic definition of finance charge, rather than to the separate disclosure rules for closed-and open-end credit.

The choice then is between amending the regulatory definition of finance charge, or adding the principle as a clarifying part of the Commentary. Since the principle accepts the current language of Regulation Z, and requires no change in that language, it would not seem necessary to amend the regulation itself.

The remaining question is whether adoption of the principle in the Commentary is an appropriate function of the Commentary. We believe it is. The whole purpose of the Commentary is to provide "official staff interpretations of Regulation Z."[193] Good faith compliance with the Commentary "protects creditors from liability for any act done or omitted in good faith in conformity with"[194] such FRB staff interpretations. The Commentary, in other words, is not intended to be a source of new, prescriptive or proscriptive rules, but rather a source of safe-harbor guidance for creditors.[195] And while some parts of the Commentary are very specific and precise, there are numerous instances where the Commentary states fairly broad principles or general policies.[196]

That is how the suggested principle is cast—not as a new or revised definition of finance charge, but merely as an authoritative statement of the circumstances in which charges for optional products

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[192] The disclosure consequences for closed-end credit are less dramatic than for open-end credit. *See infra* Part II.A.

[193] Commentary ¶ Introduction-1.

[194] *Id.*

[195] This safe-harbor function for the Commentary derives from Truth in Lending Act (TILA) § 130(f), 15 U.S.C.§ 1640(f) (2004).

[196] For example, the definition of "open-end credit" hinges on an assessment of whether the creditor "reasonably contemplates" repeated transaction. Commentary ¶ 2(a)(20)-3. Whether credit is for business or commercial purposes is a judgment for creditors to make in light of suggested factors. Commentary ¶ 3(a)-2. All disclosures for open-end credit must be "clear and conspicuous," for which the Commentary gives only general guidance. Commentary ¶ 5(a)(1)-1.

or services are not finance charges under the regulation as written. The principle could therefore be implemented by adding it to the Commentary on the regulatory definition of "finance charge."[197]

VIII. Conclusion

Under the TILA definition of finance charge, the proper characterization of fees for various kinds of optional services has remained obscure for years. Recent rulemakings by the FRB have provided answers for the specific situations presented, but have left a regrettable uncertainty as to a principled basis for the rulings. The marketplace is seeing a significant shift of creditor revenues from traditional interest to fee-based pricing. Unless TILA is to forsake its reliance on the finance charge as the most accurate measure of the cost of credit, the law needs to confront the question of when optional charges are really credit costs. We believe it can be done, if not perfectly, at least better than before, by expressing a principle that focuses not on the optional fees as such, but on the characteristics of the products and services consumers buy. If the add-on feature changes the pre-existing or underlying credit risk allocation or other essential characteristics of the credit transaction or plan, the charge for that feature is a cost of credit—a finance charge. Otherwise, it is not.

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[197] Regulation Z § 226.4.

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