PROPOSED RULES

FEDERAL RESERVE SYSTEM

12 CFR Part 226

Reg. Z; TIL-1
FR Doc. 84-31577
Filed 12-3-84

Truth in Lending; Proposed Update to Official Staff Commentary

Tuesday, December 4, 1984

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Proposed official staff interpretation.

SUMMARY: The Board is publishing for comment proposed changes to the official staff commentary to Regulation Z (Truth in Lending). The commentary applies and interprets the requirements of Regulation Z and is a substitute for individual staff interpretations of the regulation. The proposed revisions address a variety of questions that have arisen about the regulation, and include new material and changes in existing material.

DATE: Comments must be received on or before January 31, 1985.

ADDRESS: Comments should be mailed to William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, Washington, D.C. 20551, or delivered to Room B-2223, 20th and C Streets, NW., Washington, D.C. between 8:45 a.m. and 5:15 p.m. weekdays, Comments should include a reference to TIL-1. Comments may be inspected in Room B-1122 between 8:45 a.m. and 5:15 p.m. weekdays.

FOR FURTHER INFORMATION CONTACT: Contact the following attorneys in the Division of Consumer and Community Affairs, Board of Governors of the Federal Reserve System, Washington, D.C. 20551, at (202) 452-2412 or (202) 452-3867:

Subpart A--Lynn Goldfaden, Gerald Hurst

Subpart B--Richard Garabedian, Adrienne Hurt

Subpart C--Rugenia Silver, Susan Werthan

SUPPLEMENTARY INFORMATION:

I. General

The Truth in Lending Act (15 U.S.C. 1601 et seq.) governs consumer credit transactions and is implemented by the Board's Regulation Z (12 CFR Part 226). Effective October 13, 1981, and official staff commentary (TIL-1, Supp. I to 12 CFR Part 226) was published to interpret the regulation. The commentary is designed to provide guidance to creditors in applying the regulation to specific transactions. The commentary is updated periodically to address significant questions that arise. There have been three general updates so far--the first in September 1982 (47 FR 41338), the second in April 1983 (48 FR 14882), and the third in April 1984 (49 FR 13482). There was also a limited update concerning fees for the use of automated teller machines, which was adopted in October 1984 (49 FR 40560).

This notice contains the proposed fourth general update. It is expected that it will be adopted in final form in March 1985 with optional compliance until the uniform effective date of October 1 for mandatory compliance.
Certain conventions have been used to highlight the proposed revision. New language is shown inside bold-faced arrows, while language that would be deleted is set off with brackets.

II. Proposed Revisions

Following is a brief description of the proposed revisions to the commentary:

Subpart A--General

Section 226.2--Definition and Rules of Construction

2(a) Definitions

2(a)(15) "Credit Card"

Comment 2(a)(15)-2 would be revised to make clear that certain types of access devices that are used at wholesale petroleum distribution terminals--whether or not credit is involved--are not considered credit cards under Regulation Z.

2(a)(17) "Creditor"

Paragraph 2(a)(17)(i)

Comment 2(a)(17)(i)-8 would be added to explain how the numerical tests for determining who is a "creditor" should be applied to loans made by employee savings plans. It provides that the numerical test should be applied to the plan as a whole rather than to the individual account.

2(a)(20) "Open-End Credit"

Comment 2(a)(20)-5 would be revised to correct a potential contradiction caused by the language "specific approval for each extension." Because "verification" of credit information--which is permissible under the open-end credit definition--necsssary involves "approval" if a credit extension is not denied after verifying the credit information, the "specific approval" language may be confusing. The proposal would, therefore, delete that language. The comment would continue to mean, however, that while creditors may verify credit information on an open-end credit plan before authorizing additional credit extensions, they may not undertake activities such as requiring a new application for each additional credit extension, without jeopardizing a program's status as a open-end credit Plan.

Section 226.4--Finance Charge

4(a) Definition

The first sentence of comment 4(a)-3 would be revised to clarify which charges by third parties are excluded from the finance charge. The revision makes clear that, in order to be excluded, the charge must be imposed on the consumer rather than the creditor and the creditor must not retain the charge.

Subpart B--Open-End Credit

Section 226.7--Periodic Statement

7(h) Other Charges

Comment 7(h)-4 would be added to

make clear that, in disclosing "other charges" on the periodic statement, creditors have the flexibility to disclose them individually or as a total, as long as the charges are still itemized and identified by tape.

Section 226.9--Subsequent Disclosure Requirements

9(d) Finance Charge Imposed at Time of Transaction

Comment 9(d)-1 would be totally rewritten since the ban on credit card surcharges expired on February 27, 1984. Revised comment 9(d)-1 would make clear that a finance charge, such as a credit card surcharge, imposed by a person other than the card issuer for using a credit card, must be disclosed to consumers prior to their being committed to purchasing property or services, in order to satisfy the § 226.9(d)(1) requirement that the amount of that finance charge be disclosed prior to its imposition. For example, the charge must be disclosed to the consumer prior to the consumer's having dinner at a restaurant, or staying overnight at a hotel.

Section 226.12--Special Credit Card Provisions

12(a) Issuance of Credit Cards

Paragraph 12(a)(1)

Comment 12(a)(1)-8 would be added to make clear that card issuers may issue, without a specific request from the consumer, a personal identification number (PIN) to existing cardholders, provided that PIN cannot be used by itself to obtain credit. This interpretation differs from a proposed interpretation under Regulation E that prohibits such PIN issuance. The different treatment is based on the definition of an access device in Regulation E. Under Regulation E a PIN is an access device in all cases, even when it cannot be used alone to initiate an EFT; in contrast, a PIN issued to existing cardholders that cannot be used by itself to obtain credit is not a credit card under Regulation Z. The rule regarding access devices is more restrictive in part because of the consumer's potentially greater risk. See Question 5-4.5 in the proposed update to the official staff commentary to Regulation E (published elsewhere in this Federal Register issue).

Section 226.15--Right of Rescission

15(a) Consumer's Right to Rescind

Paragraph 15(a)(1)

Comment 15(a)(1)-2 would be revised to reflect the amendment to the Truth in Lending Act in Pub. L. 98-479 which permanently exempts from the right of recission individual transactions made on an open-end line of credit in accordance with a previously established credit limit.

References

Reference to § 205 of Pub. L. 98-479 would be added to the References section to reflect the permanent exemption from the right of rescission for individual credit extensions made on an open-end credit line.

Subpart C--Closed-End Credit

Section 226.17--General Disclosure

Requirements

17(a) Form of Disclosures

Paragraph 17(a)(1)

The last example in comment 17(a)(1)-5 regarding due-on-sale clauses would be deleted consistent with the proposed change in position in comment 18(q)-1.

Section 226.18--Content of Disclosures

18(f) Variable Rate

Comment 18(f)-5 would be revised to add recent federal adjustable rate mortgage regulations to the list of variable rate regulations for which footnote 43 to § 226.18(f) may be used. Under the proposal, creditors making disclosures in accord with the rules issued by the Department of Housing and Urban Development (49 FR 23580) need not make the variable rate disclosures required by § 226.18(f). Comment 18(f)-5 would also be revised to reflect a new citation to the variable rate regulation of the Federal Home Loan Bank Board. The revision is technical and reflects no substantive change in the comment.
Comment 18(f)-8 would be revised to clarify the application of the discounted variable rate rules to two types of variable rate transactions. First, a paragraph would be added to explain that transactions in which the only difference between the initial rate and the index rate at consummation results from a change in the index are not discounted transactions. Second, material would be added to address plans that have a built-in delay between index changes and implementation of those changes. In calculating a composite annual percentage rate for these plans, creditors may use an index value prior to consummation as long as it incorporates the same delay used for later rate adjustments.

18(k) Prepayment

Comment 18(k)-2 would be revised to delete the example regarding student loans with loan fees, in order to make the comment more consistent with comment 18(k)-3. Comment 18(k)-2 illustrates transactions that may require disclosures under both § 226.18(k)(1), regarding penalties for prepayment of simple interest transactions, and § 226.18(k)(2), regarding rebates for prepayment of precomputed transactions. Comment 18(k)-3 clarifies that prepaid finance charges do not require rebate disclosures. Since loan fees in student loans are normally prepaid finance charges, the continued use of that type of transaction as an example of a loan requiring a rebate disclosure is inappropriate and may cause confusion. The deletion of the example is a technical revision and does not affect the substance of either comment.

18(q) Assumption Policy

The substance of comment 18(q)-1 would be deleted and replaced by a new provision which reverses the rule on assumption policy disclosure. When uncertainty exists as to the assumability of the obligation, a negative rather than affirmative disclosure would be required. It is believed that under such circumstances, a negative disclosure would be less misleading to consumers. Since this change would reverse the current position on assumption

disclosures, it would be applied prospectively.

Section 226.23--Right of Rescission

23(f) Exempt Transactions

Comment 23(f)-8 would be added to clarify the application of the right of rescission to closed-end credit transactions arising from the conversion of an open-end credit account. Where consummation of both the closed-end and open-end credit occurs at the time the consumer enters into the open-end agreement, the closed-end disclosures may be delayed until conversion, as provided by comment 17(b)-2. Proposed comment 23(f)-8 would make clear that, if the creditor has previously complied with the rescission requirements on the open-end account, no new right of recession applies on the conversion of an account secured by the consumer's principal dwelling.

List of Subjects in 12 CFR Part 226

Advertising, Banks, Banking, Consumer protection, Credit, Federal Reserve System, Finance, Penalties, Truth in lending.

PART 226--[AMENDED]

Text of revisions. The proposed revisions to the commentary (TIL-1, Supplement 1 to 12 CFR Part 226) read as follows:

Supplement I--Official Staff Commentary--TIL-1

SUBPART A--GENERAL

Section 226.2--Definitions and Rules of Construction

2(a) Definitions

2(a)(15) "Credit Card"

2. Examples. Examples of credit cards include:
- A card that guarantees checks or similar instruments, if the asset account is also tied to an overdraft line or if the instrument directly accesses a line of credit
- A card that accesses both a credit and an asset account (that is, debit-credit card)
- An identification card that permits the consumer to defer payment on a purchase
- An identification card indicating loan approval that is presented to a merchant or to a lender, whether or not the consumer signs a separate promissory note for each credit extension.
In contrast, credit card does not include, for example [, a] :
- A check guarantee or debit card with no credit feature or agreement, even if the creditor occasionally honors an inadvertent overdraft[.]
- Any card key that must be used in order to gain access to a wholesale distribution facility to obtain petroleum products for business purposes, and the use of which is required without regard to payment terms.

2(a)(17) "Creditor"

Paragraph 2(a)(17)(i)

8. Loans from employee savings plans. Some employee savings plans permit

participants to borrow money up to a certain percentage of their account balances. In such cases, the numercial tests should be applied to the plan as a whole rather than to the individual accounts, even if the loan amount is determined by reference to the balance in an individual account and the repayments are credited to the individual account.

2(a)(20) "Open-End Credit"

5. Reusable line. The total amount of credit that may be extended during the existence of an open-end plan is unlimited because available credit is generally replenished as earlier advances are repaid. A line of credit is self-replenishing even though the plan itself has a fixed expiration date, as long as during the plan's existence the consumer may use the line, repay, and reuse the credit [without specific approval for each extension (beyond verification, for example, of] . The creditor may verify credit information such as the consumer's continued income and employment status or [of] information for security purposes [)]. This criterion of unlimited credit distinguishes open-end credit from a series of advances made pursuant to a closed-end credit loan commitment.

Section 226.4--Finance Charge

4(a) Definition.

3. Charges by third parties. Charges imposed by someone other than the creditor for services that are not required by the creditor are not finance charges, provided the charges are imposed on the consumer rather than on the creditor by the third party, and the creditor does not retain the charge. For example:
- A fee charged by a loan broker to a consumer, provided the creditor does not require the use of a broker (even if the creditor knows of the loan broker's involvement or compensates the broker)
- A tax imposed by a state or other governmental body on the credit transaction that is payable by the consumer (even if the tax is collected by the creditor)

Subpart B--Open-End Credit

Section 226.7--Periodic Statement

7(h) Other Charges.

4. Itemization--types of "other charges". Each type of "other charge" (such as late payment charges, over-the-credit-limit charges, ATM fees that are not finance charges, and membership fees) imposed during the cycle must be separately itemized; for example, disclosure of only a total of "other charges" attributable to both an over-the-crtedit-limit charge and a late payment charge would not be permissible. "Other charges" of the same type may be disclosed, however, individually or as a total. For example, three ATM fees of $1 may be listed separately or as $3.

Section 226.9--Subsequent Disclosure Requirements

9(d) Finance Charge Imposed at Time of Transaction.
1. [Ban on credit card surcharges. 15 U.S.C. 1666f provides that until February 27, 1984, no seller in any sales transaction may impose a surcharge on a cardholder who elects to use a credit

card instead of paying by cash, check, or similar means.] Disclosure prior to imposition. The requirement that the amount of a finance charge imposed at the time of the honoring a consumer's credit card be disclosed prior to its imposition requires a person imposing such a credit card surcharge to disclose its existence prior to the consumer's becoming obligated to purchase property or services.

Section 226.12--Special Credit Card Provisions

12(a) Issuance of Credit Cards.

Paragraph 12(a)(1).

8. Unsolicited issuance of PINs. A card issuer may issue to existing credit cardholders, without a specific request, personal identification numbers (PINs), thus allowing consumers to use their existing credit cards at automated teller machines, provided the PINs cannot be used alone to obtain credit.

Section 226.15--Right of Rescission

15(a) Consumer's Right to Rescind.

Paragraph 15(a)(1).

2. Exceptions. Although the consumer generally has the right to rescind with each transaction on the account, section 125(e) of the act provides an exception: [until September 30, 1985,] the creditor need not provide the right to rescind at the time of each credit extension made under an open-end credit plan secured by the consumer's principal dwelling to the extent that the credit extended is in accordance with a previously established credit limit for the plan. This limited rescission option is available whether or not the plan existed prior to the effective date of the act. [The consumer will have the right to rescind each extension made after September 30, 1985 under such a secured open-end credit plan, whether that plan was established before or after that date.]

References

Statue: §§ 113,125, [and] , 130 , and the Housing and Community Development Technical Amendments Act of 1984, (Sec. 205, Pub. L. 98-479)

1981 Changes: Section 226.15 reflects the statutory amendments of 1980, providing for a limited right of rescission [for a three-year trial period] when individual credit extensions are made in accordance with a previously established credit limit for an open-end credit plan. The 1980 amendments provided that this limited rescission right be available for a three-year trial period. However, Pub. L. 98-479 now permanently exempts such individual credit extensions from the right of rescission.

Subpart C--Closed-End Credit

Section 226.17--General Disclosure Requirements.

17(a) Form of Disclosure.

Paragraph 17(a)(1).

5. Directly related. The segregated disclosures may, at the creditor's option, include any information that is directly related to those disclosures. Directly related information includes, for example, the following:

[- A statement that a due-on-sale clause is contained in the loan document. For example, the disclosure given your § 226.18(q) may state, "Someone buying your home may, subject to conditions in the due-on-sale clause contained in the loan document, assume the remainder of the mortgage on the original terms."]

Section 226.18--Content of Disclosures

18(f) Variable Rate.

5. Other variable-rate regulations. Transactions in which the creditor is required to comply with and has complied with variable-rate regulations of other federal agencies are exempt from the requirements of § 226.18(f), by virtue of footnote 43. Those variable-rate regulations include the adjustable mortgage loan instrument regulation issued by the Federal Home Loan Bank Board (12 CFR 545.33), [(12 CFR 545.6-2(a)) and] the adjustable-rate mortgage regulation issued by the Comptroller of the Currency (12 CFR Part 29) and the adjustable-rate mortgage regulations issued by the Department of Housing and Urban Development (24 CFR Part 203 and 24 CFR Part 234). The exception in footnote 43 is also available to creditors that are required by state law to comply with the federal variable-rate regulations noted above and to creditors that are authorized by title VIII of the Depository Institutions Act of 1982 (Pub. L. 97-320) to make loans in accordance with those regulations. Creditors using this exception should comply with the timing requirements of those regulations rather than the timing requirements of Regulation Z in making the variable-rate disclosures.

8. Discounted variable-rate transactions. In some variable-rate transactions, creditors may set an initial interest rate that is not determined by the index or formula used to make later interest rate adjustments. Typically, this initial rate is lower than the rate would be if it were calculated using the index or formula. For example, a creditor may calculate interest rates according to a formula using the six-month Treasury bill rate plus a 2 percent margin. If the current Treasury bill rate is 10 percent, the creditor may forego the 2 percent spread and charge only 10 percent for a limited time, instead of setting an initial rate of 12 percent.

- When creditors use an initial rate that is not calculated using the index or formula for later rate adjustments, the disclosures should reflect a composite annual percentage rate based on the initial rate for as long as it is applied and, for the remainder of the term, the rate that would have been applied using the index or formula at the time of consummation. The rate at consummation need not be used if a contract provides for a delay in the implementation of changes in an index value. For example, if the contract specifies that payment changes are based on the index value in effect 45 days before the change date, creditors may use the index value 45 days before consummation in calculating a composite annual percentage rate.
- The effect of the multiple rates must also be reflected in the calculation and disclosure of the finance charge, total of payments, and payment schedule.
- If a loan contains a rate or payment cap that would prevent the initial rate or payment, at the time of the first adjustment, from changing to the rate determined by the index or formula at consummation, the effect of that rate or

payment cap should be reflected in the disclosures.
- Because these transactions involve irregular payment amounts, an annual percentage rate tolerance of 1/4 of 1 percent applies, in accordance with § 226.22(a)(3) of the regulation.
- Examples of discounted variable-rate transactions include:
--A 30-year loan for $100,000 with no prepaid finance charges and rates determined by the Treasury bill rate plus 2 percent. Rate and payment adjustments are made annually. Although the Treasury bill rate at the time of consummation is 10 percent, the creditor sets the rate for one year at 9 percent, instead of 12 percent according to the formula. The disclosures should reflect a composite annual percentage rate of 11.63 percent based on 9 percent for one year and 12 percent for 29 years. Reflecting those two rate levels, the payment schedule should show 12 payments of $804.62 and 348 payments of $1,025.31. The finance charge should be $226,463.32 and the total of payments $366,463.32.
--Same loan as above, except with a 2 percent rate cap on periodic adjustments. The disclosures should reflect a composite annual percentage rate of 11.53 percent based on 9 percent for the first year, 11 percent for the second year, and 12 percent for the remaining 28 years. Reflecting those three rate levels, the payment schedule should show 12 payments of $804.62, 12 payments of $950.09, and 336 payments of $1,024.34. The finance charge should be $265,234.76, and the total of payments $365,234.76.
This paragraph does not apply to variable-rate loans in which the initial rate is set according to the index or formula used for later adjustments, but is not set at the value of the index or formula at consummation. For example, if a creditor commits to an initial rate based on the formula on a date prior to consummation, but the index has moved during the period between that time and consummation, a creditor may base its disclosures on the initial rate.

18(k) Prepayment.

2. . Rebate-penalty disclosure. A single transaction may involve both a precomputed finance charge and a finance charge computed by application of a rate to the unpaid balance (for example, [simple-interest student loans with loan fees and] mortgages with mortgate-guarantee insurance). In these cases, disclosures about both prepayment rebates and penalties are required. Sample form H-15 in appendix H illustrates a mortgage transaction in which both rebate and penalty disclosures are necessary.

18(q) Assumption Policy.

1. Policy statement. [Because a creditor's assumption policy may be based on a variety of circumstances not determinable at the time the disclosure is made, the creditor may use phrases such as "subject to conditions" or "under certain circumstances" in complying with § 226.18(q). The provision requires only that the consumer be told whether or not a subsequent purchaser might be allowed to assume the obligation on its original terms and does not contemplate any explanation of the criteria or conditions for assumability. However, the creditor may state that a due-on-sale clause is contained in the loan document. (See comment 17(a)(1)-5 regarding

directly related information.)] In making the disclosure required by this section, if uncertainty exists as to whether a subsequent purchaser will be allowed to assume the obligation on its original terms, the creditor should state that the obligation cannot be assumed on its original terms. For example, if the obligation is subject to a due-on-sale clause, it is viewed as being nonassumable for purposes of complying with this section. However, if the only uncertainty pertains to a determination of the creditworthiness of the subsequent purchaser, the obligation is viewed as being assumable and an affirmative disclosure is appropriate.

Section 226.23--Right of Rescission

23(f) Exempt Transactions

8. Converting open-end to closed-end credit. Under certain state laws, consummation of a closed-end credit transaction may occur at the time a consumer enters into the initial open-end credit agreement. As provided in the commentary to § 226.17(b), closed-end credit disclosures may be delayed under these circumstances until the conversion of the open-end account to a closed-end transaction. In accounts secured by the consumer's principal dwelling, no new right of rescission arises at the time of conversion, assuming that the right of rescission arises at the time of conversion, assuming that the right of rescission was previously provided on the open-end account pursuant to § 226.15.

(15 U.S.C. 1604)
Board of Governors of the Federal Reserve System, November 28, 1984.

William W. Wiles,

Secretary of the Board.