

PROPOSED RULES  
FEDERAL RESERVE SYSTEM

12 CFR Part 226

Reg. Z; Docket No. R-0545A  
FR Doc. 86-26249  
Filed 11-21-86

Proposed Update to Official Staff  
Commentary

Monday, November 24, 1986

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 proposed commentary would offer guidance to creditors in complying with the provisions of a proposed amendment to Regulation Z that is being published for comment in this issue of the Federal Register. The regulatory amendment would require creditors to provide more information about certain variable-rate loans than is currently required. The proposed revisions include new material as well as numerous technical changes in existing material. The text of the major additions proposed for the commentary begins with comment 226.18(f)(2)-1, which follows the summary of proposed commentary revisions.

DATE: Comments must be received on or before January 20, 1987.

ADDRESS: Comments should be mailed to William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, Washington, DC 20551, or delivered to the 20th Street courtyard entrance, 20th Street, between C Street and Constitution Avenue, NW., Washington, DC, between 8:45 a.m. and 5:15 p.m. weekdays. Comments should include a reference to Docket No. R-0545A. Comments may be inspected in Room B-1122 between 8:45 a.m. and 5:15 p.m. weekdays.

FOR FURTHER INFORMATION  
CONTACT: Sharon Bowman, Staff Attorney, or Michael Bylsma, Senior Attorney, Division of Consumer and Community Affairs, at (202) 452-2412 or (202) 452-3667, or Earnestine Hill or Dorothea Thompson, Telecommunications Device for the Deaf, at (202) 452-3544, Board of Governors of the Federal Reserve System, Washington, DC 20551.

SUPPLEMENTARY INFORMATION:

(1) Background

This proposed official staff interpretation is being published in conjunction with the proposed amendment to Regulation Z to provide more information to consumers about variable-rate mortgage transactions secured by a consumer's principal dwelling. The commentary would apply and interpret the requirements of this proposed amendment to Regulation Z. It is expected that these revisions, pending public comment on the proposed amendments to the regulation and the commentary, will be adopted in final form in April 1987, with optional compliance until the date for mandatory

compliance of October 1, 1987.

## (2) Proposed Revisions

The following is a brief description of the proposed revisions to the commentary:

### Subpart C--Closed-End Credit

#### Section 226.17--General Disclosure Requirements

##### 17(a) Form of Disclosures

Paragraph 17[a][1]. The information contained in the fifth bullet under comment 17(a)(1)-5, which discusses disclosure of a variable-rate feature on other documents, would be deleted, since similar information would be required under new paragraph (f)(2) of § 226.18. In addition, the ninth bullet under comment 17(a)(1)-5 (discussing negative amortization) would be revised to change the reference from § 226.18(f)(3) to new § 226.18(f)(1)(iii).

##### 17(b) Time of Disclosures

Comment 17(b)-1 would be expanded to cover the timing requirements for variable-rate mortgage transactions secured by the consumer's principal dwelling. This expansion points out the new early timing requirement contained in proposed § 226.19(b) for these variable-rate mortgages.

##### 17(c) Basis of Disclosures and Use of Estimates

Paragraph 17(c)(1). The first bulleted paragraph in comment 17(c)(1)-2 (discussing preferential employee rates) would be revised to change the reference

from § 226.18(f) to § 226.19(b). This change would clarify that certain preferred-rate employee loans are variable-rate transactions subject to the new disclosure requirements of proposed § 226.19(b). In addition, comment 17(c)(1)-9 would be revised to incorporate material on discounted variable-rate transactions currently comprising comment 18(f)-8. Similarly, the material currently in comment 18(f)-6 would be incorporated in comment 17(c)(1)-10 as examples of other variable-rate transactions. The reference in the second bullet under comment 18(f)-6 to including the conditions for imposition of the shared-appreciation feature would be deleted, as would the reference to the hypothetical example in the third bullet under this comment. In addition, the discussion on graduated-payment mortgages and step-rate transactions without a variable-rate feature would be deleted. The material currently in comment 18(f)-7 would be incorporated in new comment 17(c)(1)-11, although the language requiring disclosure of the fact that payments may increase, as well as the circumstances of and any limits on such an increase, would be deleted. This material previously in comments 18(f)-6 through 18(f)-8 would be included in the commentary to § 226.17 since it illustrates the disclosures generally required under Truth in Lending for these transactions. As a result of these additions, existing comments 17(c)(1)-9 (on Morris Plans) and 17(c)(1)-10 (concerning the number of transactions) would be redesignated as 17(c)(1)-12 and 17(c)(1)-13, respectively.

##### 17(f) Early Disclosures

As a result of the proposed revisions to §

226.19 of the regulation, the reference in comment 17(f)-3 to § 226.19(b) would be revised to reference § 226.19(a)(2).

## Section 226.18--Content of Disclosures

### 18(f) Variable Rate

Comment 18(f)-1 would be expanded to clarify that variable-rate loans secured by the consumer's principal dwelling are subject to the special early disclosure requirements of proposed § 226.19(b). Comments 18(f)-5 through 18(f)-8 would be deleted. The material currently in comments 18(f)-6 through 18(f)-8 would be moved to paragraph 17(c)(1) to illustrate the disclosures generally required under Truth in Lending. The material currently in comment 18(f)-5 would be moved to new § 226.19(b), which contains the new disclosure requirements. Similarly, the material currently in comment 18(f)-6 would be moved to new comment § 226.19(b)-4 to clarify that these transactions are subject to this section's general disclosure requirements, with certain enumerated exceptions. The information currently in comment 18(f)-6 relating to the basis for disclosures would not be transferred to new comment 19(b)-4.

The current headings referring to paragraphs 18(f) (1) through (4) would be changed to reference paragraphs 18(f)(1) (i) through (iv) to reflect the fact that current § 226.18(f) of the regulation would become § 226.18(f)(1).

Comment 18(f)(2)-1 would be added to clarify that, where a variable-rate transaction is secured by the consumer's principal dwelling, later Truth in Lending disclosures must state that the variable-rate feature exists, as well as refer to the variable-rate disclosures that should have been provided to consumers

earlier pursuant to proposed § 226.19(b).

## Section 226.19--Certain Residential Mortgage Transactions

The title of this section of the commentary would be changed to read "Certain Residential and Variable-Rate Mortgage Transactions" to parallel the proposed change to § 226.19 of the regulation. That section now incorporates the new disclosure provisions for variable-rate mortgages secured by the consumer's principal dwelling.

### 19(a) Time of Disclosure

Since paragraph 19(b) would be revised to encompass the new material concerning variable-rate mortgage transactions secured by the consumer's principal dwelling, the current heading referring to 19(a) would be redesignated as 19(a)(1). Existing comments 19(a)-1 through 19(a)-5 would become comments 19(a)(1)-1 through 19(a)(1)-5.

### 19(b) Redislosure Required

As a result of the change to paragraph 19(b) to incorporate new material, the current heading referring to 19(b) would be redesignated as 19(a)(2). Existing comments 19(b)-1 through 19(b)-4 would become comments 19(a)(2)-1 through 19(a)(2)-4.

Comment 19(b)-1 would be added to clarify that the proposed new requirements of § 226.19(b) would apply to all transactions in which the annual percentage rate may increase after consummation and where the transaction is secured by the consumer's principal dwelling.

Comment 19(b)-2 would be added to

explain the timing for disclosures pursuant to proposed § 226.19(b). It clarifies that creditors must generally give the disclosures required under this section when an application form is provided or before a non-refundable fee is paid, whichever is earlier. The comment also offers guidance on situations where the creditor receives applications through an intermediary agent or broker. It explains that, in such cases, the creditor may deliver the required disclosures or mail them no later than three business days after the creditor receives the written application. Comment 19(b)-3, which was previously included in the general variable-rate discussion under § 226.18(f) as comment 18(f)-5, would be added to this section of the commentary to clarify that creditors may substitute information provided in accordance with the variable-rate regulations of other federal agencies for the disclosure requirements of § 226.19(b). The references to footnote 43 and § 226.18(f) would be changed to reference footnote 45a and § 226.19(b), respectively.

Comment 19(b)-4, which incorporates material previously included in comment 18(f)-6, would be added to this section of the commentary to clarify that such transactions are subject to the general disclosure requirements of § 226.19(b), with certain enumerated exceptions. The last sentence in the first bullet under comment 18(f)-6 referring to the disclosures that must be given for renegotiable rate mortgages would be deleted, as would the third and fourth sentences in the second bullet under this comment dealing with disclosures for shared-equity mortgages. In the discussion on preferred-rate employee loans contained in the third bullet under comment 18(f)-6, the language would be

revised to take into account transactions where the initial underlying rate is fixed, and the reference to the hypothetical example in the last sentence would be deleted.

Paragraph 19(b)(1). Comment 19(b)(1)-1 would be added to make clear that a creditor must provide either the Consumer Handbook on Adjustable Rate Mortgages or a suitable substitute to consumers at an early stage of the application process. It explains that the substitute should at least be comparable to the Consumer Handbook in substance and comprehensiveness, but may offer more detailed information about ARMs than the Consumer Handbook.

Paragraph 19(b)(2). Comment 19(b)(2)-1 would be added to explain that a creditor must provide disclosures for each of the creditor's variable-rate programs in which the consumer expresses an interest, as well as any additional disclosures requested after initial disclosures have been made under this section. Comment 19(b)(2)-2 would be added to clarify that the disclosures required under proposed § 226.19(b)(2) need only be made as applicable, and comment 19(b)(2)-3 would explain the circumstances under which a creditor must give revised disclosures under this section.

Comments to proposed § 226.19(b)(2) (i) through (xiv) have been added to describe the requirements imposed by these paragraphs concerning disclosure of detailed, specific information about all major aspects of a variable-rate transaction secured by a consumer's principal dwelling. In general, under proposed § 226.19(b)(2), creditors would be required to identify the index to which interest rate changes are tied, or provide a brief description of the formula used in calculating changes if no

index is used, as well as disclose a source of information about the index. Proposed § 226.19(b)(2) would also require an explanation of how a consumer's interest rate and payment will be determined and a statement telling consumers to ask for the current margin value and interest rate. Creditors would also need to provide consumers with information about a discount feature when the initial rate is discounted, and disclose the frequency of rate and payment adjustments, as well as the existence of rate and payment caps. If no payment or rate caps exist, the disclosure would indicate conspicuously that there are no limits on potential increases in payments or rates. If the presence of rate or payment caps would result in interest rate carryover or negative amortization, the disclosure statement would need to contain a reference to those features. A creditor would also have to disclose if a loan program contains a demand feature, and state what information will be contained in an adjustment notice and when such notice will be provided. Creditors would also be required to provide consumers with a statement that disclosure forms are available for other variable-rate loan programs. In addition to these disclosures, § 226.19(b)(2) would require creditors to provide a fifteen-year historical example of how changes in the index or formula values used to compute interest rates would have affected the interest rates and payments on a \$10,000 loan made at the beginning of that period. The creditor would also need to disclose the maximum interest rate and payment that could result under the loan program for a \$10,000 loan. Section 226.19(b)(2) would also require a creditor to explain how a consumer can calculate his or her

payments for a loan amount other than \$10,000.

The comments to paragraphs 19(b)(2) (i) through (xiv) would clarify these proposed disclosure requirements and illustrate how a creditor may comply with these provisions.

## Section 226.20--Subsequent Disclosure Requirements

### 20(b) Assumptions

Comment 20(b)-6 would be amended to clarify that assumptions of variable-rate transactions secured by the consumer's principal dwelling are not subject to the disclosure provisions of proposed §§ 226.18(f)(2)(ii) or 226.19(b).

### 20(c) Variable-Rate Adjustments

Comment 20(c)-1 would be added to explain what subsequent disclosures are required in cases where a rate adjustment is scheduled in a variable-rate transaction subject to proposed § 226.19(b). Comment 20(c)-2 would clarify that shared-equity loans and preferred-rate employee loans with an underlying fixed rate would be exempt from the proposed subsequent disclosure requirements of § 226.20.

## Appendix H--Closed-End Model Forms and Clauses

Appendix H has been revised to illustrate the new disclosures that would be required under the proposed regulatory amendments. Model H-4 would contain model forms H-4(A), H-4(B), H-4(C), and H-4(D), with commentary provided for each form. Model H-4(A) contains the material currently in Model H-4, while Model H-

4(B) would be added to illustrate the variable-rate disclosures required under proposed § 226.18(f)(2). Similarly, Model H-4(C) would be added to illustrate the early disclosures required under proposed § 226.19(b), while Model H-4(D) would be added to explain the requirements of the adjustment notice provided for in proposed § 226.20(c). These additions would be numbered as paragraphs four through seven in Appendix H. Existing paragraphs five through eight, which incorporate commentary on Models H-5 through H-9, would be renumbered as paragraphs eight through eleven. The commentary to current Sample H-14 would be replaced by commentary for the new Sample H-14. It explains how a creditor may adapt the model clauses in Model H-4(C) to the creditor's own particular variable-rate program. As a result of the addition of Models H-4(B) through H-4(D), current paragraphs nine through twenty in Appendix H, which incorporate commentary on the sample forms, would be renumbered as paragraphs twelve through twenty-three.

#### List of Subjects in 12 CFR Part 226

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

Certain conventions have been used to highlight the proposed revisions. New language is shown inside arrows, while language that would be removed is set off with brackets. Pursuant to authority granted in section 105 of the Truth in Lending Act (15 U.S.C. 1604 as amended), the Board proposes to amend the official staff commentary to Regulation Z (12 CFR Part 226 Supp. I) as follows:

#### PART 226--[AMENDED]

(1) The authority citation for Part 226 continues to read:

Authority: Sec. 105, Truth in Lending Act, as amended by sec. 605, Pub. L. 96-221, 94 Stat. 170 (15 U.S.C. 1604 et seq.).

(2) Text of proposed revisions. The proposed revisions to the commentary (Supplement I to 12 CFR Part 226) include removing the information contained in the fifth bullet under comment 17(a)(1)-5 and changing the reference in the ninth bullet under this comment from § 226.18(f)(3) to § 226.18(f)(1)(iii); revising comment 17(b)-1, changing the reference in the first bullet under comment 17(c)(1)-2 from § 226.18(f) to § 226.19(b); redesignating existing comments 17(c)(1)-9 and 17(c)(1)-10 as comments 17(c)(1)-12 and 17(c)(1)-13, respectively and adding new comments 17(c)(1)-9 through 17(c)(1)-11; changing the reference in comment 17(f)-3 from § 226.19(b) to § 226.19(a)(2); revising comment 18(f)-1; removing comments 18(f)-5 through 18(f)-8; redesignating comments 18(f)(1)-1, 18(f)(2)-1, 18(f)(3)-1, 18(f)(4)-1 and 18(f)(4)-2 as comments 18(f)(1)(i)-1, 18(f)(1)(ii)-1, 18(f)(1)(iii)-1, 18(f)(1)(iv)-1, and 18(f)(1)(iv)-2, respectively; adding new comment 18(f)(2)-1; revising the title to the commentary on § 226.19; redesignating paragraphs 19(a) and 19(b) as paragraphs 19(a)(1) and 19(a)(2), respectively; redesignating comments 19(a)-1 through 19(a)-5 as comments 19(a)(1)-1 through 19(a)(1)-5 and comments 19(b)-1 through 19(b)-4 as 19(a)(2)-1 through 19(a)(2)-4; adding

new comments 19(b), (b)(1), (2) and (2)(i)-(xiv); revising comment 20(b)-6 introductory text and the concluding paragraph and adding comments 20(c)-1 and 20(c)-2; amending the commentary to Appendix H by redesignating H-5 through H-20 as H-8 through H-23, adding new comments H-5 through H-7, and revising newly redesignated H-18, to read as follows:

#### Supplement I--Proposed Official Staff Interpretation

#### Section 226.17--General Disclosure Requirements.

##### 17(b) Time of disclosures.

1. Consummation. As a general rule, disclosures must be made before "consummation" of the transaction. The disclosures need not be given by any particular time before consummation, except in certain mortgage transactions and variable-rate mortgage transactions secured by the consumer's principal dwelling under § 226.19. (See the commentary to § 226.2(a)(13) regarding the definition of consummation.)

##### 17(c) Basis of Disclosures and Use of Estimates.

##### Paragraph 17(c)(1)

9. 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 charged to consumers is lower than the rate would be if it were calculated using the index or formula. However, in some cases the initial rate may be higher. In a

discounted transaction, 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 Treasury bill rate at consummation is 10 percent, the creditor may forgo 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 interest 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 charged 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 rate changes are based on the index value in effect 45 days before the change date, creditors may use the index value in effect not more than 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 interest 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 \$266,463.32 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.

--Same loan as above, except with a 7 1/2 percent cap on payment adjustments. The disclosures should reflect a composite annual percentage rate of 11.64 percent, based on 9 percent for one year and 12 percent for 29 years. Because of the payment cap, five levels of payment should be reflected. The payment schedule should show 12 payments of \$804.62, 12 payments of

\$864.97, 12 payments of \$929.86, 12 payments of \$999.60, and 312 payments of \$1,070.03. The finance charge should be \$277,037.96, and the total of payments \$377,037.96.

This paragraph does not apply to variable-rate loans in which the initial interest 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 should base its disclosures on the initial rate.

10. Other variable-rate transactions.

Examples of variable-rate transactions include:

- Renegotiable rate mortgage instruments that involve a series of short-term loans secured by a long-term obligation, where the lender is obligated to renew the short-term loans at the consumer's option. At the time of renewal, the lender has the option of increasing the interest rate. Disclosures must be given for the longer term of the obligation, with all disclosures calculated on the basis of the rate in effect at the time of consummation of the transaction.

- "Shared-equity" or "shared-appreciation" mortgages that have a fixed rate of interest and an appreciation share based on the consumer's equity in the mortgaged property. The appreciation share is payable in a lump sum at a specified time. Disclosures must be based on the fixed interest rate. If the transaction is not secured by the consumer's principal dwelling, the creditor should refer to comment 18(f)-1. Disclosures under § 226.18(f) would include, for example, the time at which



the shared appreciation would be collected and the limitation on the creditor's share. If the transaction is secured by the consumer's principal dwelling the creditor should refer to § 226.19(b). (As discussed in § 226.2, other types of shared-equity arrangements are not considered "credit" and are not subject to Regulation Z.)

- Preferred-rate employee loans where the terms of the legal obligation provide that the rate will increase only if the employee leaves the employ of the creditor and the note reflects the preferred rate. The disclosures are to be based on that rate.

11. Growth-equity mortgages. Also referred to as payment-escalated mortgages, these mortgage plans involve scheduled payment increases to prematurely amortize the loan. The initial payment amount is determined as for a long-term loan with a fixed interest rate. Payment increases are scheduled periodically, based on changes in an index. The larger payments result in accelerated amortization of the loan. In disclosing these mortgage plans, creditors may either:

- Estimate the amount of payment increases, based on the best information reasonably available; or
- Disclose by analogy to the variable-rate disclosures. (This discussion does not apply to growth-equity mortgages in which the amount of payment increases can be accurately determined at the time of disclosure. For these mortgages, as for graduated-payment mortgages, disclosures should reflect the scheduled increases in payments.)

## Section 226.18--Content of Disclosures

### 18(f) Variable Rate

1. Coverage. The requirements of § 226.18(f) apply to all transactions in which the terms of the legal obligation allow the creditor to increase the rate originally disclosed to the consumer. It includes not only increases in the interest rate but also increases in other components, such as the rate of required credit life insurance. The provisions, however, do not apply to increases resulting from delinquency (including late payment), default, assumption, acceleration or transfer of the collateral. Moreover, loans in which the annual percentage rate may increase after consummation and where the transaction is secured by the consumer's principal dwelling are subject to the special early disclosure requirements of § 226.19(b).

### 18(f)(2)

1. Disclosure required. In a variable-rate transaction that is secured by the consumer's principal dwelling, the creditor must give special early disclosures under § 226.19(b) in addition to the later Truth in Lending disclosures required under § 226.18(f)(2). The creditor, in making disclosures under § 226.18(f)(2), must state that the variable-rate feature exists and that variable-rate disclosures have been provided earlier.

## Section 226.19--Certain Residential <and Variable-Rate" Mortgage Transactions .

### 19(b) "Variable-Rate Mortgage Transactions

1. Coverage. The requirements of § 226.19(b) apply to all transactions in which the annual percentage rate may increase after consummation and where the transaction is secured by the

consumer's principal dwelling. It includes not only purchase-money mortgages, where the consumer obtains a mortgage loan to purchase a home, but also other closed-end transactions in which the consumer uses the home as security for a loan. All other variable-rate transactions which are not secured by the consumer's principal dwelling are subject to the disclosure requirements of § 226.18(f)(1).

2. Timing. A creditor must generally give the disclosures required under this section at the time an application form is provided or before the consumer pays a non-refundable fee, whichever is earlier. In cases where a creditor receives a written application through an intermediary agent or broker, however, footnote 45b provides that the creditor shall deliver the disclosures or place them in the mail not later than three business days after the creditor receives the consumer's written application.

3. 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 § 226.19(b), by virtue of footnote 45a. Those variable-rate regulations include the adjustable mortgage loan instrument regulation issued by the Federal Home Loan Bank Board (12 CFR 545.33), and the adjustable-rate mortgage regulation issued by the Comptroller of the Currency (12 CFR 29), and the adjustable-rate mortgage regulations issued by the Department of Housing and Urban Development (24 CFR 203 and 24 CFR 234). The exception in footnote 45a 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 (12 U.S.C. 3801 et seq.) 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.

4. Examples of variable-rate transactions. The following transactions, if secured by the consumer's principal dwelling, constitute variable-rate transactions subject to the disclosure requirements of § 226.19(b) unless specifically exempted. (If these variable-rate transactions are not secured by the consumer's principal dwelling, disclosures pursuant to § 226.18(f)(1) must be provided.)

- Renegotiable rate mortgage instruments that involve a series of short-term loans secured by a long-term obligation, where the lender is obligated to renew the short-term loans at the consumer's option. At the time of renewal, the lender has the option of increasing the interest rate.

- "Shared-equity" or "shared-appreciation" mortgages that have a fixed rate of interest and an appreciation share based on the consumer's equity in the mortgaged property. The appreciation share is payable in a lump sum at a specified time. Sections 226.19(b)(2) (iv), (v), (ix), (x), (xi) and (xiii) do not apply to shared-equity mortgages, however. (As discussed in § 226.2, other types of shared-equity arrangements are not considered "credit" and are not subject to Regulation Z.)

- Preferred-rate employee loans where the terms of the legal obligation provide that the initial underlying rate is fixed, but will increase if the employee leaves the employ of the creditor, and the note

reflects the preferred rate. The disclosures are to be based on that rate. Where the underlying fixed-rate loan has such a variable-rate feature, the disclosures under §§ 226.19(b)(2) (ix), (x), (xiii) and (xiv) are inapplicable. (Graduated-payment mortgages and step-rate transactions without a variable-rate feature are not considered variable-rate transactions.)

#### Paragraph 19(b)(1)

1. Substitutes. Creditors who wish to use ARM information publications other than the Consumer Handbook on Adjustable Rate Mortgages must make a good faith determination that their brochures are suitable substitutes to the Consumer Handbook. A substitute is suitable if it is, at a minimum, comparable to the Consumer Handbook in substance and comprehensiveness. Creditors are permitted to provide more detailed information about ARMs than is contained in the Consumer Handbook.

#### Paragraph 19(b)(2)

1. Disclosure for each variable-rate program. In variable-rate transactions subject to § 226.19(b) requirements, a creditor must provide disclosures that fully describe each of the creditor's variable-rate loan programs in which the consumer expresses an interest at the time an application form is provided or before the consumer pays a non-refundable fee, whichever is earlier. Moreover, if a consumer requests disclosures for other ARM programs, a creditor must provide disclosures for as many other of the creditor's ARM programs as the consumer requests.

2. As applicable. The disclosures required by this section need only be

made as applicable. Any disclosure not relevant to a particular transaction may be eliminated. For example, if the transaction does not contain a demand feature, the disclosure required under § 226.19(b)(2)(xii) need not be given.

3. Revisions. A creditor must revise the disclosures required under this section generally in two circumstances--once a year when the new index value becomes available and when the loan program changes.

#### Paragraph 19(b)(2)(i)

1. Change in interest rate, payment, or term. A creditor must disclose the fact that the terms of the legal obligation permit the creditor, after consummation of the transaction, to increase (or decrease) the interest rate, payment, or term of the loan initially disclosed to the consumer. For example, the disclosures might read, "Your payment can change yearly based on changes in the interest rate."

#### Paragraph 19(b)(2)(ii)

1. Identification of index or formula. If a creditor ties interest rate changes to a particular index, this fact must be disclosed, along with a source of information about the index. For example, if a creditor uses the 1-year Treasury Bill rate as its index, the disclosure might read, "Your index is the rate for a 1-year Treasury Bill adjusted to a constant maturity published weekly in the Wall Street Journal." If no particular index is used, the creditor must briefly describe the formula used to calculate interest rate changes.

2. Changes at creditor's discretion. If interest rate changes are at the creditor's discretion, this fact must be disclosed. If

an index is internally defined, such as by a creditor's prime rate, the creditor should either briefly describe that index or state that interest rate changes are at the creditor's discretion.

#### Paragraph 19(b)(2)(iii)

1. Determination of interest rate and payment. This section requires an explanation of how the creditor will determine the consumer's interest rate and payment. In cases where a creditor bases its interest rate on a specific index (such as the 1-year Treasury Bill rate) and adjusts the index through the addition of a margin, for example, the disclosure might read, "Your interest rate is based on the index plus a 2% margin, and your payment will be based on the interest rate."

#### Paragraph 19(b)(2)(iv)

1. Current margin value and interest rate. Because the disclosures can be prepared in advance, the interest rate and margin may be several months old when the disclosures are delivered. A statement, therefore, is required alerting the consumers to the fact that they should inquire about the current margin value applied to the index and the current interest rate. For example, the disclosure might state, "You should ask us for our current interest rate and margin."

#### Paragraph 19(b)(2)(v)

1. Discounted interest rate. 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 charged to consumers is lower than the rate would

be if it were calculated using the index or formula. However, in some cases the initial rate may be higher. If the initial interest rate contains a discount feature, creditors must alert the consumer to this fact, as well as disclose the amount of the discount and the period for which the low initial rate applies. For example, if a creditor discounted a consumer's initial rate for six months, the disclosure might state, "Your initial interest rate is not based on the index used to make later adjustments and will be 3 percentage points lower than the index and margin for the first six months." (See the commentary to § 226.17(c)(1) for a further discussion of discounted variable-rate transactions.) This paragraph does not apply to variable-rate loans in which the initial interest 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, this paragraph does not apply 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.

#### Paragraph 19(b)(2)(vi)

1. Frequency. The frequency of interest rate and payment adjustments must be disclosed. If interest rate changes will be imposed more frequently or at different intervals than payment changes, then a creditor must reveal the frequency and timing of both types of changes. For example, in a variable-rate transaction where interest rate changes are made monthly, but payment changes would only occur on an annual basis, this fact must be disclosed.

#### Paragraph 19(b)(2)(vii)

1. Rate and payment caps. If the variable-rate transaction limits changes (increases or decreases) in the interest rate or payment, the creditor must disclose those limitations.
2. Negative amortization and interest rate carryover. A creditor must disclose, where applicable, the possibility of negative amortization. For example, the disclosure might state, "If any of your payments is not sufficient to cover the interest due, the difference will be added to your loan amount." In addition, the creditor must disclose the existence of any interest rate carryover provisions. For example, if the index rises 3 percentage points during the year, the loan contains a 2 percentage cap on annual changes (increases or decreases) in the interest rate, and the creditor may impose the additional percentage point the following year, the creditor must disclose the fact that changes in the index will be carried over to subsequent interest rate adjustment dates. The disclosure might state, "Changes in the index not passed on as changes in the interest rate will be carried over to subsequent interest rate adjustment dates."
3. Conversion option. If a loan program permits consumers to convert their variable-rate loans to fixed-rate mortgages at a designated time, the rules relating to this feature must be disclosed.
4. Preferred-rate employee loans. This provision applies to preferred-rate employee loans, where the rate will increase if the employee leaves the creditor's employ, whether or not the underlying rate is fixed or variable. For example, in transactions where the terms of the legal obligation provide that the initial underlying rate is variable, but

also provide that the rate will increase if the employee leaves the employ of the creditor, the creditor must disclose that the rate may increase if the employee leaves the creditor's employ.

#### Paragraph 19(b)(2)(viii)

1. Conspicuous statement. The requirement that a creditor provide a "conspicuous" statement that there are no limits on increases in a borrower's payment or interest rate may be satisfied through the use of boldface print, underscoring, or capital letters to disclose this information. (See the commentary to § 226.17(a)(2) for additional information concerning how to make disclosures more conspicuous.)

#### Paragraph 19(b)(2)(ix)

1. Index movement. This section requires a creditor to provide an historical example, based on a \$10,000 loan amount originating in 1977, showing how interest rate changes implemented according to the terms of the loan program would have affected payments and the loan balance at the end of each year during a 15 year period. Pursuant to this section, the creditor must provide a history of index values for the preceding 15 years. Initially, the disclosures would give a 10-year history of the index values beginning with 1977 values. Each year thereafter, disclosures pursuant to this section would include an additional year of index values until 15 years of values are shown. The 15-year history in the disclosures must reflect the most recent 15 years of index values. If the values for an index have not been available for 15 years, a creditor need only go back as far as the values are available in giving a history. If a creditor

uses an index value as of a certain date, which is changed several times annually, the creditor may assume one date on which to base the history of index values. In all cases, only one index value per year need be shown. Thus, in transactions where interest rate adjustments are implemented more frequently than once per year, a creditor may assume that the interest rate and payment resulting from the index value chosen will stay in effect for the entire year for purposes of calculating the loan balance as of the end of the year and for reflecting other loan program terms. Moreover, if a creditor uses an average of index values or any other index formula, the history given should reflect those values. In cases where interest rate changes are at the creditor's discretion (see the commentary to § 226.19(b)(2)(ii)), the creditor must provide a history of the rates imposed for the preceding period, beginning with an initial 10-year history of rates starting in 1977. Each year thereafter, disclosures would include an additional year until 15 years of index values are shown. In giving this history, the creditor need only go back as far as the creditor's rates can reasonably be determined.

2. Selection of margin. For purposes of the disclosure required under § 226.19(b)(2)(ix), a creditor may select a margin that has been used during the six months preceding preparation of the disclosures, and should disclose that the margin is one that the creditor has used recently. A creditor is permitted to assume a representative margin in order to make calculations for the historical example required under this section since the disclosure form must be given early in the application process. The margin selected may be used until a

creditor updates the disclosure form to reflect the most recent index values.

#### Paragraph 19(b)(2)(x)

1. Calculation of payments. A creditor is required to include a statement on the disclosure form that explains how a consumer may calculate his or her actual monthly payments for a loan amount other than \$10,000. The example should be based upon the most recent payment shown in the historical example. The creditor, however, is not required to calculate the consumer's payments. (See the model clauses in H-4(C).)

#### Paragraph 19(b)(2)(xi)

1. Maximum interest rate and payment. The disclosure form must state the maximum interest rate and payment for a \$10,000 loan, based on the most recent interest rate shown in the historical example. In calculating the maximum payments under this section, a creditor should assume that the interest rate has increased as rapidly as possible under the loan program, and the maximum payment disclosed should reflect the amortization of the loan during this period. Thus, in a loan with 2 percent annual (and 5 percent overall) interest rate limitations or "caps," the maximum interest rate would be 5 percentage points higher than the most recent rate shown in the historical example. Moreover, the loan would not reach the maximum interest rate increase until the third year because of the 2 percent annual rate limitations, and the maximum payment disclosed would reflect the amortization of the loan during this period. The requirement that the maximum interest rate and payment be disclosed would not be required if the

loan contained no caps, although the disclosure under § 226.19(b)(2)(viii) would state that there are no limits on potential increases in rates or payments.

#### Paragraph 19(b)(2)(xii)

1. Demand feature. If a variable-rate loan subject to § 226.19(b) requirements contains a demand feature, this fact must be disclosed. (Pursuant to § 226.18(i), creditors would also disclose the demand feature in the standard disclosures given later.)

#### Paragraph 19(b)(2)(xiii)

1. Adjustment notices. A creditor must disclose to the consumer what information will be contained in subsequent notices of adjustments and when such notices will be provided. (See § 226.20(c) regarding notices of adjustments.) For example, in transactions providing that payment adjustments may accompany each interest rate adjustment, the disclosure might state, "You will be notified at least 30, but no more than 120, days before the effective date of any scheduled interest rate adjustment that may be accompanied by a payment adjustment. This notice will contain information about the index and interest rates, payment amount, and loan balance." In transactions where the creditor would be required to send at least one notice each year during which there have been interest rate adjustments without accompanying payment adjustments, the disclosure might read, "You will be notified once each year during which interest rate adjustments, but no payment adjustments, have been made to your loan. This notice will contain information about the index and interest

rates, payment amount, and loan balance."

#### Paragraph 19(b)(2)(xiv)

1. Multiple loan programs. A creditor who offers multiple variable-rate loan programs is required to have disclosures for each variable-rate loan program offered pursuant to § 226.19(b)(2). The creditor must inform the consumer that other variable-rate programs exist, and that disclosure forms are available for these additional loan programs. For example, the disclosure form might state, "Information on other ARM programs is available upon request."

### Section 226.20--Subsequent Disclosure Requirements.

#### 20(b) Assumptions

6. Disclosures. For transactions that are assumptions within this provision, the creditor must make disclosures based on the "remaining obligation." For example:

If a transaction involves add-on or discount finance charges, the creditor may make abbreviated disclosures, as outlined in § 226.20(b) (1) through (5). Creditors providing disclosures pursuant to this section for assumptions of variable-rate transactions secured by the consumer's principal dwelling need not provide new disclosures under § 226.18(f)(2)(ii) or 226.19(b).

#### 20(c) Variable-Rate Adjustments

1. Additional disclosures. This section would require a creditor to provide certain limited disclosures in cases where an adjustment to the interest rate is scheduled in a variable-rate

transaction subject to § 226.19(b). A notice of a scheduled rate adjustment must be sent to the consumer, whether or not the scheduled rate adjustment is accompanied by a corresponding adjustment to the consumer's payment. There are two timing rules, depending on whether payment changes may accompany interest rate changes. In transactions where the interest rate may be adjusted more frequently than the payment, a creditor is required to send at least one notice each year during which interest rate adjustments have occurred without accompanying payment adjustments. In transactions providing for payment adjustments to accompany each interest rate adjustment, a creditor must notify borrowers at least 30, but not more than 120, days before the effective date of each scheduled rate adjustment. The disclosure must include the new payment amount, the current and prior interest and index rates and the loan balance, as well as notify the consumer of the extent to which any increase in the interest rate has been foregone. The disclosure must also state the payment that would be required to fully amortize the loan if this amount is different from the payment already disclosed. Information about this adjustment notice should be provided to the consumer in the variable-rate loan disclosures provided under § 226.19(b)(2)(xiii).

2. Exceptions. Section 226.20(c) does not apply to shared-equity loans and preferred-rate employee loans with an underlying fixed rate.<sup>G7</sup>.

#### Appendix H--Closed-End Model Forms and Clauses

5. Model H-4(B). This model clause illustrates the variable rate disclosure required under § 226.18(f)(2), which

would alert consumers to the fact that the transaction contains a variable-rate feature and that earlier disclosures were provided under § 226.19(b) in cases where the variable-rate transaction is secured by the consumer's principal dwelling.

6. Model H-4(C). This model clause illustrates the early disclosures required generally under § 226.19(b) when the variable-rate transaction is secured by the consumer's principal dwelling. It includes information on how the consumer's interest rate is determined and how it can change over the term of the loan, and explains changes that may occur in the borrower's monthly payment. In variable-rate loans where there are no limits on increases in the borrower's interest rate or in the monthly payment (other than limits on changes in interest rates), this fact must be expressed conspicuously. The model clause includes an example of this disclosure. (See the commentary to § 226.19(b)(2)(viii) for a discussion of what is included in the meaning of the term "conspicuous.") The model clause also contains an example of how to disclose historical changes in the index or formula values used to compute interest rates for the preceding 15 years. In addition, the model clause illustrates the disclosure required to explain how a consumer may calculate his or her actual monthly payments for a loan amount other than \$10,000.

7. Model H-4(D). This model clause illustrates the adjustment notice required under § 226.20(c). The notice should contain the new payment amount, the current and prior interest and index rates, and the loan balance. The adjustment notice must also disclose the extent to which any increase in interest rate has been foregone, and, where different from



the payment already disclosed, the payment that would be required to fully amortize the loan.G7.

18. Sample H-14. This sample disclosure form illustrates the disclosures under section 19(b) for a variable-rate mortgage where the annual percentage rate may increase after consummation and the transaction is secured by the consumer's principal dwelling. The sample form shows a creditor how to adapt the model clauses in Appendix H-4(C) to the creditor's own particular variable-rate program. The sample disclosure form describes the features of a specific variable-rate mortgage program and alerts the consumer to the fact that information on other variable-rate programs is available upon request. It includes information on how the borrower's interest rate is determined and how it can change over time, and explains how the monthly payment can change based on a \$10,000 loan amount, payable in 360 monthly installments, based on historical changes in the values for a 1-year Treasury Bill adjusted to a constant maturity for the period of January 1977 to January 1986. This 10-year history reflects the requirement under § 226.19(b)(2)(ix) that the index history begin with index values for 1977. Thus, the index history in 1986 would contain only 10 years of index values. In making these disclosures in 1991, however, a creditor would need to show a 15-year index history beginning with the values in 1977. The sample disclosure also illustrates the requirement under § 226.19(b)(2)(xi) that the maximum interest rate and payment be shown for a \$10,000 loan originated at the most recent rate shown in the historical example. In the sample, the loan is assumed to have an initial

interest rate of 10.73% (which was the rate in 1986 for the index used) and has 2 percent annual (and 5 percent overall) interest rate limitations or caps. Thus, the maximum amount that the interest rate could rise under this program is 5 percentage points higher than the 10.73% initial rate to 15.73%, and the monthly payment could rise from \$94.39 to a maximum of \$131.59. The loan would not reach the maximum interest rate increase until its third year because of the 2 percent annual rate limitations, and the maximum payment disclosed would reflect the amortization of the loan during that period. The sample disclosure form also reflects the requirement that, in cases where there is no limit on increases in the borrower's monthly payments (other than limits on increases in interest rates), that this fact must be stated conspicuously. (See the commentary to § 226.19(b)(2)(viii) for a discussion of what is included in the meaning of the term "conspicuous.") The sample form also illustrates how to provide consumers with a method for calculating their actual monthly payment for a loan amount other than \$10,000. Board of Governors of the Federal Reserve System, November 17, 1986.

William W. Wiles,

Secretary of the Board.