PROPOSED RULES

FEDERAL RESERVE SYSTEM

12 CFR Part 226

Reg. Z; TIL-1
FR Doc. 86-26963
Filed 12-01-86

Truth in Lending; Proposed Update to Official Staff Commentary

Tuesday, December 2, 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 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.

As a result of the potential for increased use of home-equity lines of credit and second mortgage loans due to the new limitations on the deductibility of non-business interest expenses under the revised federal tax laws, the Board has received a number of inquiries concerning real estate secured extensions of credit. These questions are addressed by several proposals, one of which would clarify the rules that apply when a creditor adds a security interest in the consumer's principal dwelling to a transaction that was previously exempt from the regulation.

The proposal includes a variety of other provisions, including clarification of the prohibition against offsetting a consumer's credit card indebtedness with funds from a deposit account held with a credit card issuer, and clarification of the refinancing exception for transactions with lower annual percentage rates.

DATE: Comments must be received on or before January 30, 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 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: The following attorneys in the Division of Consumer and Community Affairs at (202) 452-3667 or (202) 452-3867:

Open-end--Kathleen Brueger, Heather Hansche, Susan Kraeger

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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) 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, an official staff commentary (TIL-1, Supp. 1 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 five general updates so far--the first in September 1982 (47 FR 41338), the second in April 1983 (48 FR 14882), the third in April 1984 (49 FR 13482), the fourth in April 1985 (50 FR 13181), and the fifth in April 1986 (51 FR 11422). 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 sixth general update. It is expected that it will be adopted in final form in March 1987 with optional compliance until the uniform effective date of October 1 for mandatory compliance.

(2) Proposed Revisions

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

Subpart A--General

Section 226.2--Definitions and Rules of Construction.

2(a) Definitions.

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

Comment 2(a)(20)-4 would be amended to clarify that the open-end credit definition does not require that a finance charge be included or that the possibility of a finance charge exist for a plan to qualify as an open-end credit plan.

Section 226.3--Exempt Transactions

3(b) Credit Over $25,000 Not Secured by Real Property or a Dwelling

Comment 3(b)-2 would be amended to clarify that an open-end credit plan which was exempt from coverage by the regulation under § 226.3(b) becomes subject to the regulation when a security interest is taken in real property or personal property used or expected to be used as the consumer's principal dwelling.

Comment 3(b)-3 would be amended by correcting the reference to the $25,000 limitation and by adding a reference to the consumer's principal dwelling in the first sentence. The revisions clarify the rule that disclosures for previously exempt closed-end credit transactions are required only when the existing obligation is satisfied and replaced by a new obligation. A cross-reference to the commentary to § 226.23(a)(1), which discusses the right of rescission when a security interest in a consumer's principal dwelling is added to a previously exempt transaction, would also be added to the comment.

Section 226.4--Finance Charge

4(c) Charges Excluded from the Finance

Charge

Paragraph 4(c)(4)

Comment 4(c)(4)-1 would be amended to further clarify the types of charges that may be treated as participation or membership fees. Specifically, the amended comment would make clear that a one-time charge imposed when an account is opened, such as a loan origination fee, may not be treated as a participation fee. In addition, language would be added to make clear that fees based on the degree of account activity are not participation fees.

Subpart B--Open-End Credit

Section 226.5--General Disclosure Requirements

5(b) Time of Disclosures

Paragraph 5 (b)(1)

Comment 5(b)(1)-1 would be revised to make clear that, in general, the initial disclosure must be provided to the consumer before the consumer pays any fees or charges under the plan, including real estate charges of the type excluded from the finance charge in § 226.4(c)(7). However, the comment would continue to allow imposition of an application fee or membership fee prior to giving the initial disclosure statement (provided it is refunded if the consumer rejects the plan).

Section 226.6--Initial Disclosure Statement

6(b) Other Charges

Comment 6(b)-1 would be amended by adding examples of the types of real estate charges included in §226.4(c)(7), and deleting taxes and filing or notary fees excluded from the finance charge under § 226.4(e) as an example of an "other charge." Since fees excluded from the finance charge under § 226.4(e) must be itemized and disclosed it seems unnecessary to specifically require them to be treated as "other charges" in order to ensure that they are disclosed to the consumer.

6(c) Security Interests

Comments 6(c)-2 and 6(c)-4 would be revised to take into account the Board's Credit Practices Rule, Subpart B of Regulation AA, 12 CFR Part 227, and the credit practices rules of the Federal Trade Commission and the Federal Home Loan Bank Board, 16 CFR Part 444 and 12 CFR Part 535, respectively. These rules deem it an unfair or deceptive act or practice for creditors to take or enforce a nonpurchase money, nonpossessory security interest in household goods, as that term is defined by the rules. As a result, the references to "household appliances" and "household goods" have been deleted from comments 6(c)-2 and 6(c)-4, respectively, to avoid any confusion on the part of creditors. A new example--stocks and bonds--has been substituted for household goods in comment 6(c)-4.

Section 226.7--Periodic Statement

7(f) Amount of Finance Charge

A new comment 7(f)-8 would be added to clarify when finance charges that are assessed at the time an account is opened must be disclosed on the periodic statement.

7(h) Other Charges.

Comment 7(h)-1 would be amended to make clear that creditors may, under certain circumstances, disclose, as a single amount, charges imposed in connection with real estate transactions that are excluded from the finance charge under § 226.4(c)(7).

Section 226.12--Special Credit Card Provisions.

12(d) Offsets by Card Issuer Prohibited.

Paragraph 12(d)(2).

Comment 12(d)(2)-1 would be revised to clarify the security interest exception to the prohibition on a credit card issuer's offsetting a cardholder's indebtedness against funds of the cardholder that are on deposit with the card issuer. The comment would make clear that the exception does not include a security interest that is the functional equivalent of the right of offset. Therefore, security interests granted by language routinely included in credit card agreements are not within the exception. For the exception to apply, there must be some indication that the consumer is aware that a security interest is a condition for an account (or for more favorable terms on an account) and specifically intends to grant the security interest. The revised comment would give examples of what might serve to indicate that the condition discussed above is met.

The proposed changes are the result of inquiries about whether the regulation permits creditors to routinely take security interests in deposit accounts of cardholders by including "boilerplate" language in cardholder agreements. In December 1985, the Board proposed changes to comment 12(d)(2)-1 to clarify that routinely including such provisions in cardholder agreements violated the offsets prohibition (50 FR 50794). Final action on that proposed change was postponed, however, to allow for further review of the comments received and to more fully explore the concerns raised and the issues involved (51 FR 11422).

The current proposal--as well as the December 1985 proposal--seeks to clarify the security interest exception in § 226.12(d), which implements section 169 of the Truth in Lending Act. Section 169 prohibits a card issuer from offsetting a cardholder's indebtedness under the credit card plan against funds of the cardholder held on deposit with the card issuer. Since the statute provides only one exception to this prohibition--for plans in which the cardholder authorizes the card issuer to make periodic deductions from a deposit account held with the card issuer--questions arose in the past as to whether a cardholder's deposit accounts could ever serve as security for credit card indebtedness.

Recognizing that there were instances where security interests were called for--for example, an applicant may be required to provide collateral to obtain or retain a credit card account--the Board provided in Regulation Z that consensual security interests in deposit accounts could be taken without violating the offset prohibition. There is some evidence, however, that this position has been interpreted as allowing card issuers to debit cardholders' accounts pursuant to language routinely included in all cardholder contracts that takes a security interest in deposit accounts. Such a practice is inconsistent with the statutory

prohibition and its legislative history. The legislative history of section 169 reveals that Congress was concerned about the effects of the right of offset on consumers. For example, an offset against a checking account could result in the depositor's checks being dishonored. In addition, the issuer's ability to offset might deprive the consumer of the ability to effectively assert a billing error under section 161 or a claim or defense under section 170 of the act. The legislative history also indicates that there was concern that the right of offset gave card issuers that were depository institutions an unfair advantage over other creditors that had to apply to a court before being permitted to attach funds.

A security interest in a cardholder's deposit accounts that is created by routinely including language in cardholder agreements appears to raise the same concerns that the Congress sought to address by prohibiting the right of offset. As a result, certain steps must be followed by creditors in taking security interests in deposit accounts to avoid rendering the offsets prohibition meaningless. The proposed changes would set forth certain limitations on the exception.

The current proposal addresses the concerns of some of the commenters on last year's proposal who believed more flexibility was needed. For example, the current proposal does not specify any one item, such as reference to a specific amount of deposit account funds, as being necessary to qualify for the exception. Rather, a specific amount is included as one of several factors that could evidence the consumer's awareness of and intent to grant a security interest.

Section 226.15--Right of Rescission.

15(c) Delay of Creditor's Performance.

Comment 15(c)-1 would be amended to clarify that a creditor is not prohibited from disbursing funds during the rescission period when property subject to the right to rescind is added as security under an existing open-end credit plan.

Comment 15(c)-3 would be revised to clarify that the examples of actions a creditor may take during the rescission period are permissible actions provided they are not prohibited by state law or other requirements. This revision was prompted by the fact that some creditors mistakenly believed that the regulation authorized the accrual of finance charges during the rescission period, even when state law does not permit the practice. The revision makes it clear that the regulation neither authorizes nor prohibits the listed actions.

Subpart C--Closed-End Credit

Section 226.18--Content of Disclosures.

18(g) Payment Schedule.

Paragraph 18(9)(2).

Comment 18(9)(2)-1 would be revised to take into account transactions in which interest and principal payments occur at different intervals. The revision would clarify that a creditor may disclose the two series of payments separately and use an abbreviated payment schedule for the interest payments. The revision also makes clear that this option is available for transactions in which interest and principal payments are scheduled on the same as well as on different dates of the

month.

18(m) Security Interest.

Comment 18(m)-2 concerning the manner of disclosing a nonpurchase money security interest would be revised to take into account the Board's Credit Practices Rule, Subpart B of Regulation AA, 12 CFR Part 227, and the credit practices rules of the Federal Trade Commission and the Federal Home Loan Bank Board, 16 CFR Part 444 and 12 CFR Part 535, respectively. These rules deem it an unfair or deceptive act or practice for creditors to take or enforce a nonpurchase money, nonpossessory security interest in household goods, as that term is defined by the rules. Therefore, household goods would be deleted from comment 18(m)-2 as an example of how to identify a nonpurchase money security interest in the Truth in Lending disclosures.

Section 226.20--Subsequent Disclosure Requirements.

20(a) Refinancings.

Paragraph 20(a)(2).

The discussion in comment 20(a)(2)-1 on what qualifies as a corresponding change in the payment schedule would be deleted, as a result of the addition of comment 20(a)(2)-2.
Comment 20(a)(2)-2 would be added to clarify what is a corresponding change in the payment schedule that would not require additional disclosures. The addition makes clear, for example, that a reduction in the annual percentage rate accompanied by an increase in the term of the original obligation is an event requiring additional disclosures.

Section 226.23--Right of Rescission.

23(a) Consumer's Right to Rescind.

Paragraph 23(a)(1).

Comment 23(a)(1)-5 would be modified to clarify the circumstances in which the addition of a security interest to a preexisting obligation is rescindable. The revised comment would make clear that if a transaction was previously exempt from the regulation because it was credit over $25,000 not secured by real property or a principal dwelling, and a security interest in a consumer's principal dwelling is later added to the transaction, the consumer has the right to rescind the addition of a security interest even if the existing obligation is not satisfied and replaced by a new obligation.

23(c) Delay of Creditor's Performance.

Comment 23(c)-3 would be revised to clarify that the examples of actions a creditor may take during the rescission period are permissible actions provided they are not prohibited by state law or other requirements. This revision was prompted by the fact that some creditors mistakenly believed that the regulation authorized the accrual of finance charges during the rescission period, even when state law does not permit such a practice. The revision makes it clear that the regulation neither authorizes nor prohibits the listed actions.

Appendix D--Multiple-Advance Construction Loans.

Comment app. D-5 would be added to explain the way in which "interest

reserves" for multiple advance construction loans should be treated when a creditor uses Appendix D to calculate the annual percentage rate and disclosures. The Board has received a number of questions pertaining to the treatment of interest reserves and particularly whether or not the sum should be treated as a prepaid finance charge. The proposal would not require creditors using Appendix D to treat an interest reserve as a prepaid finance charge. If, however, a creditor requires a consumer to establish an interest reserve and provides that interest that accrues on the loan will be automatically deducted from the interest reserve, the estimated interest must reflect the fact that interest will accrue on the interest payments as well as the other loan proceeds. The proposal explains how to account for that accrual.

List of Subjects in 12 CFR Part 226

Advertising, Banks, Banking, Consumer protection, Credit, Finance, Penalties, Truth in lending.
Certain conventions have been used to highlight the proposed revisions. New language is shown inside bold-faced arrows, while language that would be deleted is set off with brackets.

PART 226--[AMENDED]

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

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 revisions. The proposed revisions to the commentary (TIL-1, Supplement I 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)(20) "Open-End Credit".

4. Finance charge on an outstanding balance. The requirement that a finance charge may be computed and imposed from time to time on the outstanding balance means that there is no specific amount financed for the plan for which the finance charge, total of payments, and payment schedule can be calculated. A plan may meet the definition of open-end credit even though it does not provide for finance charges. [A plan does not meet this criterion if there is no possibility that a finance charge will be imposed on the outstanding balance. Some plans, such as certain "china club" plans, feature free ride periods if the consumer pays all or a specified portion of the outstanding balance within a given time period. For example, the creditor might not impose finance charges in any month in which the consumer pays 1/10 of the balance. Thus, a plan could meet this finance charge criterion even though the consumer actually pays no finance

charges during the existence of the plan because the consumer takes advantage of the option to pay the balance (either in its entirety or in installments) within the time necessary to avoid finance charges.]

Section 226.3--Exempt Transactions.

3(b) Credit over $25,000 not secured by real property or a dwelling.

2. Open-end credit. An open-end credit plan is exempt under § 226.3(b) (unless secured by real property or personal property used or expected to be used as the consumer's principal dwelling) if either of the following conditions is met:
- The creditor makes a firm commitment to lend over $25,000 with no requirement of additiona! credit information for any advances.
- The initial extension of credit on the line exceeds $25,000.
If a security interest is taken at a later time in any real property, or personal property used or expected to be used as the consumer's principal dwelling, the plan would no longer be exempt. The creditor would be required to comply with all of the requirements of the regulation. If the security interest being added is in the consumer's principal dwelling, compliance would include giving the consumer the right to rescind the security interest. (See the commentary to §226.15 concerning the right of rescission.)

3. Refinanced obligations. A closed-end loan for over $25,000 may later be rewritten for $25,000 or less than [$25,000] or a security interest in real property, or personal property used or expected to be used as the consumer's principal dwelling, may be added to an extension of credit for over $25,000. Such a transaction is consumer credit requiring disclosures only if the existing obligation is satisfied and replaced by a new obligation made for consumer purposes undertaken by the same obligor. (See the commentary to section 226.23(a)(1) regarding the right of rescission when a security interest in a consumer's principal dwelling is added to a previously exempt transaction.)

Section 226.4--Finance Charge.

4(c) Charges excluded from the finance charge.

Paragraph 4(c)(4).

1. Participation fees. The participation fees mentioned in section 226.4(c)(4) do not necessarily have to be formal membership fees, nor are they limited to credit card plans. The provision applies to any credit plan in which payment of a fee is a condition of access to the plan itself, but it does not apply to fees imposed separately on individual closed-end transactions. The fee may be charged on a monthly, annual, or other periodic basis [as well as annually; however,]; a one-time, non-recurring fee imposed at the time an account is opened is not a fee that is charged on a periodic basis, and may not be treated as a partic pation fee. In addition, minimum monthly charges, charges for no--use of a credit card, and [or] other charges based on [current] account activity are not excluded from the finance charge by § 226.4(c)(4). (See the commentary to § 226.4(b)(2).)

Subpart B--Open-End Credit

Section 226.5--General disclosure requirements.

5(b) Time of disclosures.

Paragraph 5(b)(1).

1. Disclosure before the first transaction. The rule that the initial disclosure statement must be furnished "before the first transaction" requires delivery of the initial disclosure statement before the consumer becomes obligated on the plan (for example, before the consumer makes the first purchase, receives the first advance, or pays [a fee] any fees or charges under the plan).

Section 226.6--Initial disclosure statement.

6(b) Other charges.

1. General; examples of other charges. Under section 226.6(b), significant charges related to the plan (that are not finance charges) must also be disclosed. For example:
- Charges imposed in connection with real estate transactions such as title fees, appraisals, and credit reports (See section 226.4(c)(7).)
[- Taxes and filing or notary fees excluded from the finance charge under section 226.4(e).]

6(c) Security interests.

2. Identification of property. Identification of the collateral by type is satisfied by stating, for example, "motor vehicle. " [or "household appliances."] The creditor may, at its option, provide a more specific identification (for example, a model and serial number.)

4. Additional collateral. If collateral is required when advances reach a certain amount, the creditor should disclose the information available at the time of the initial disclosures. For example, if the creditor knows that a security interest will be taken in [household goods] stocks or bonds if the consumer's balance exceeds $1,000, the creditor should disclose accordingly.

Section 226.7--Periodic statement.

7(f) Amount of finance charge.

8. Start-up fees. Points, loan fees, or similar charges relating to the opening of the account that are paid prior to the issuance of the first periodic statement need not be disclosed on the periodic statement. If, however, these charges are financed as part of the plan, including charges that are paid out of the first advance, the charges must be disclosed on the first periodic statement.

7(h) Other charges.

1. Identification. In identifying any "other charges" actually imposed during the billing cycle, the type is adequately described as "late charge" or "membership fee," for example. Similar!y, "closing costs" or "settlement costs" may be used to describe charges imposed in connection with real estate transactions that are excluded from the finance charge under § 226.4(c)(7), provided the same term (for example, "closing costs") was used in the initial disclosures when the costs included in the term were itemized and individually disclosed. (See comment 6(b)-1 for examples of "other charges.")

Section 226.12--Special credit card provisions.

12(d) Offsets by card issuer prohibited.

Paragraph 12(d)(2).

1. Security interest--limitations. In order to qualify for the exception stated in § 226.12(d)(2), a security interest must be affirmatively agreed to by the consumer and must be disclosed in the issuer's initial disclosures under § 226.6 [, and must be obtained and enforced only through procedures equally available to other creditors.]. The security interest must not be the functional equivalent of a right of offset; as a result, routinely including in agreements contract language that indicates that consumers are giving a security interest in any deposit accounts maintained with the issuer does not come within the security interest exception in § 226.12(d)(2). For a security interest to qualify for the exception under § 226.12(d)(2) the following conditions must be met:
(1) The consumer must be aware that granting a security interest is a condition for the credit card account and must specifically intend to grant a security interest in a deposit account. Indicia of the consumer's awareness and intent could include, for example--
- Separate signature or initials on the agreement indicating that a security interest is being given.
- Placement of the security agreement on a separate page, or otherwise separating the security interest provisions from other contract and disclosure provisions.
- Reference to a specific amount of deposited funds or to a specific deposit account number.
(2) The security interest must be obtained and enforced only through procedures equally available to other creditors. If other creditors could not obtain a security interest in the consumer's deposit accounts in the same manner as the card issuer, the security interest is prohibited by § 226.12(d)(2). An example of a permissible security interest in deposit account funds would be one in which [For example,] the consumer [may offer] offers a savings account (as an alternative to other personal property, such as an automobile) as security [for credit card indebtedness] in order to qualify for a credit card line.
Another example of a permissible security interest in deposit account funds would be one granted by the consumer in return for an incentive offered by the issuer (for example, lower rates on the credit card account).

Section 226.15--Right of rescission.

15(c) Delay of creditor's performance.

1. General rule. Until the rescission period has expired and the creditor is reasonably satisfied that the consumer has not rescinded, tne creditor must not, either directly or through a third party:
- Disburse advances to the consumer.
- Begin performing services for the consumer.
- Deliver materials to the consumer.
A creditor may, however, continue to allow transactions under an existing open-end credit plan during a rescission period that results solely from the addition of a security interest in the consumer's principal dwelling. (See comment 15(c)-3 for other permissible actions.)

3. Permissible actions. Section 226.15(c) does not prevent the creditor from taking other steps during the delay, short of beginning actual performance. Unless

otherwise prohibited, such as by state law, the [The] creditor may, for example:
- Prepare the cash advance check.
- Perfect the security interest.
- Accrue finance charges during the delay period.

Subpart C--Closed-End Credit

Section 226.18--Content of disclosures.

18(g) Payment schedule.

Paragraph 18(g)(2).

1. Abbreviated disclosure. The creditor may disclose an abbreviated payment schedule when the amount of each regularly scheduled payment (other than the first or last payment) includes an equal amount to be applied on principal and a finance charge computed by application of a rate to the decreasing unpaid balance. This option is also available when mortgage-guarantee insurance premiums, paid either monthly or annually, cause variations in tne amount of the scheduled payments, reflecting the continual decrease or increase in the premium due. In addition, in transactions in which interest is paid at intervals different from those for principal payments, the two series of payments may be disclosed separately and the abbreviated payment schedule may be used for the interest payments. For example, in transactions where quarterly principal payments remain fixed, monthly payments of interest will vary quarterly because of application of a rate to the unpaid principal balance each quarter; in such cases, the creditor may treat the interest and principal payments as consecutive payments within two separate series of payments and use an abbreviated payment schedule to disclose the interest payments. This option may be used when interest and principal are scheduled to be paid on the same date of the month as well as on different dates of the month. The creditor using this alternative must disclose the dollar amount of the highest and lowest payments and make reference to the variation in payments.

18(m) Security interest.

2. Nonpurchase money transactions. In nonpurchase money transactions, the property subject to the security interest must be identified by item or type. This disclosure is satisfied by a general disclosure of the category of property subject to the security interest, such as ["household goods,"] "motor vehicles[,]" or "securities." At the creditor's option, however, a more precise identification of the property or goods may be provided.

Section 226.20--Subsequent disclosure requirements.

20(a) Refinancings.

Paragraph 20(a)(2).

1. Annual percentage rate reduction. A reduction in the annual percentage rate with a corresponding change in the payment schedule is not a refinancing. [A corresponding change in the payment schedule could include, for example, a change in the maturity or a reduction in the payment amount or the number of payments.] If the annual percentage rate is subsequently increased (even though it remains below its original level) and the increase is effected in such a way that the old obligation is satisfied and

replaced, new disclosures must then be made.
2. Corresponding change. A corresponding change in the payment schedule to implement a lower annual percentage rate would be a shortening of the maturity

or a reduction in the payment amount or the number of payments of an obligation. The exception in § 226.20(a)(2) does not apply if the maturity is lengthened or if the payment amount or number of payments is increased beyond that remaining on the existing transaction.

Section 226.23--Right of rescission.

23(a) Consumer's right to rescind.

Paragraph 23(a)(1).

5. Addition of a security interest. Under footnote 47, the addition of a security interest to a preexisting obligation is rescindable even if the existing obligation is not satisfied and replaced by a new obligation. The right of rescission applies only to the added security interest, however, and not to the original obligation. In those situations, only the § 226.23(b) notice need be delivered, not new material disclosures; the rescission period will begin to run from the delivery of the notice. If the transaction involved was previously exempt from the regulation because it was credit over $25,000 not secured by real property or a consumer's principal dwelling, and a security interest in a consumer's principal dwelling is later added to the transaction, the right to rescind the addition of the security interest must be provided to the consumer even if the existing obligation is not satisfied and replaced by a new obligation.

23(c) Delay of creditor's performance.

3. Permissible actions. Section 226.23(c) does not prevent the creditor from taking other steps during the delay, short of beginning actual performance. Unless otherwise prohibited, such as by state law, the [The] creditor may, for example:
- Prepare the loan check.
- Perfect the security interest.
- Prepare to discount or assign the contract to a third party.
- Accrue finance charges during the delay period.

Appendix D--Multiple-Advance Construction Loans

5. Interest reserves. In a multiple-advance construction loan, a creditor may establish an "interest reserve" to ensure that interest is paid as it accrues by designating a portion of the loan to be used for paying the interest that accrues on the loan. In such cases the interest reserve need not be treated as a prepaid finance charge. If, however, a creditor automatically deducts payments of interest from the preestablished sum (rather than allowing the consumer to make the payments as they become due), the estimated interest must reflect the fact that interest will accrue on those interest payments as well as the other loan proceeds. For purposes of estimating the additional interest resulting from compounding a creditor shall assume that one-half of the interest initially computed is outstanding at the contract interest rate for the entire construction period. For example:

- Using the example shown under Part I.A. of Appendix D, the estimated interest would be $1,117.68 ($1093.75 plus an additional $23.93 calculated by assuming half of $1093.75 is outstanding at the contract interest rate for the entire construction period), and the estimated annual percentage rate would be 21.18%.

Board of Governors of the Federal Reserve System, November 24, 1986.

William W. Wiles,

Secretary of the Board.