RULES and REGULATIONS

FEDERAL RESERVE SYSTEM

12 CFR Part 226

Reg. Z; TIL-1
FR Doc. 87-7410
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Truth in Lending; Official Staff Commentary Update

Monday, April 6, 1987

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final official staff interpretation.

SUMMARY: The Board is publishing in final form 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 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 increased use of home-equity lines of credit and second mortgage loans, partly 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 revisions, one of which clarifies 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 update includes a variety of other revisions including clarification of the exception from the finance charge for participation or membership fees under § 226.4(c)(4), and clarification of the prohibition against offsetting a consumer's credit card indebtedness with funds from a deposit account held with a credit card issuer under § 226.12(d).

DATES: Effective April 1, 1987, but compliance optional until October 1, 1987.

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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. 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 five general updates so far. This notice contains the sixth general update, which was proposed for comment on December 2, 1986 (51 FR 43372). The changes are effective on April 1, 1987. Although creditors are free to rely on the provisions as of that date and are protected if they do so, they need not follow the revisions until October 1, 1987.

(2) Revisions

The following is a brief description of the 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 is amended to further clarify that an open-end credit plan may exist even though the creditor does not normally impose a finance charge, provided the creditor has the right to impose a finance charge from time to time on the outstanding balance. Section 226.3--Exempt Transactions-- 3(b) Credit Over $25,000 Not Secured by Real Property or a Dwelling-- Comment 3(b)-2 is amended to clarify that an open- end credit plan which was exempt from the regulation's coverage under § 226.3(b) becomes subject to the regulation when a security interest is taken in any real property, or in personal property used or expected to be used as the consumer's principal dwelling. As a result, creditors must give the consumer an initial disclosure statement reflecting the current account terms at the time such security interest is taken, and comply with the other provisions of the regulation applicable to open-end credit. If the security interest that is taken is in the consumer's principal dwelling, the creditor must also give the consumer the right to rescind the security interest. Comment 3(b)-3 is amended to correct the reference to the $25,000 limitation and to add a reference to the consumer's principal dwelling in the first sentence. In addition, the caption "Refinanced obligations" has been changed to "Closed-end credit--subsequent changes" to more closely parallel the language used in the caption for the preceding comment on open-end credit. 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, has also been 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 is amended and a new comment 4(c)(4)-2 is added to clarify the types of charges that may be treated as participation or membership fees, and thus excluded from the finance charge. Specifically, comment 4(c)(4)-1 is amended to 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. Comment 4(c)(4)-2 is added to make clear that fees based on either the degree

of account activity or on the amount of credit available under the plan (such as a fee based on a percentage of the credit limit) are not participation fees and, if imposed, must be treated as finance charges.

Subpart B--Open-End Credit

Section 226.5--General Disclosure Requirements--5(b) Time of Disclosures-- 5(b)(1) Initial disclosures. Comment 5(b)(1)-1 is revised to make clear that, in general, the initial disclosure statement 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 (§ 226.4(c)(1)) or membership fee (§ 226.4(c)(4)) prior to giving the initial disclosure statement; any membership fee imposed before the initial disclosures are given must be refunded if the consumer rejects the plan.

Section 226.6--Initial Disclosure Statement--6(b) Other Charges-- Comment 6(b)-1 is amended by adding examples of the types of real estate charges included in § 226.4(c)(7). In addition, taxes and filing or notary fees excluded from the finance charge under § 226.4(e) are deleted as examples of an "other charge" in comment 6(b)-1, and comment 6(b)-2 is amended to include them as examples of what is not an "other charge." Since taxes and filing or notary fees excluded from the finance charge under § 226.4(e) must be itemized and disclosed, it is unnecessary to specifically require them to be treated as "other charges" in order to ensure that they are disclosed to the consumer. The creditor has the option of either itemizing and disclosing these fees separately under § 226.4(e), or including the fees as part of the initial disclosure statement as an "other charge" under § 226.6(b). Under either option, the creditor may disclose the amount of the fees or, alternatively, an explanation of how the amount will be determined.

6(c) Security Interests. Comments 6(c)-2 and 6(c)-4 are 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 declare 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. Some state laws also limit the availability of security interests in household goods. Comments 6(c)-2 and 6(c)-4 have been supplemented with parenthetical statements designed to alert creditors to the existence of these restrictions, rather than deleting the references to "household appliances" and "household goods" altogether, as was originally proposed.

Section 226.7--Periodic Statement-- 7(f) Amount of Finance Charge. A new comment 7(f)-8 is added to clarify that finance charges assessed at the time an account is opened must be disclosed on the periodic statement if they are financed under the plan.

7(h) Other Charges. Comment 7(h)-1 is amended to make clear that creditors may disclose real estate-related charges excluded from the finance charge under § 226.4(c)(7) as a single amount with a term such as "closing costs" on the

periodic statement, if the charges were itemized and described by the same term on the initial disclosure. Creditors may continue, however, to disclose these charges on the initial disclosure statement by explaining how the charge will be determined (see § 226.6(b)).
Section 226.12--Special Credit Card Provisions--12(d) Offsets by Card Issuer Prohibited--Paragraph 12(d)(2).
Comment 12(d)(2)-1 is revised to clarify that the security interest exception to the prohibition on offsetting a cardholder's indebtedness against funds on deposit with the card issuer 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 affirmative 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. In addition, to qualify for the exception, a security interest in the consumer's deposit account must be obtainable and enforceable by creditors generally. The revised comment eliminates the examples at the end of the previous comment since they are now incorporated in the requirements discussion.
Section 226.15--Right of Rescission--15(c) Delay of Creditor's Performance.
Comment 15(c)-1 is 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 is 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. In addition, the caption "Permissible actions" has been changed to "Actions during the delay period." These revisions were 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 revisions make 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(g)(2). Comment 18(g)(2)-1 is reVised to incorporate a discussion of transactions in which interest and principal payments occur at different intervals. The revision clarifies 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, addressing disclosure of nonpurchase money security interests, is revised to reflect the existence of 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, 16 CFR Part 444, and the Federal Home Loan Bank Board, 12 CFR Part 535. These rules declare it an unfair or deceptive act or practice for creditors to take or enforce a

nonpossessory, nonpurchase money security interest in "household goods," as that term is defined by the rules. Some state laws also limit the availability of security interests in household goods. Comment 18(m)-2 has therefore been supplemented with a parenthetical statement designed to alert creditors to the existence of these restrictions.

Rather than deleting the reference to "household goods" altogether, as was originally proposed, an additional example has been provided: "certain household items." Some creditors have expressed reluctance, in light of the credit practices rules, to use the term "household goods." Accordingly, the additional term has been provided in comment 18(m)-2 as an alternative means of describing this type of property.

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

Section 226.23--Right of Rescission--23(a) Consumer's Right to Rescind--Paragraph 23(a)(1). Comment 23(a)(1)-5 is modified to clarify the circumstances in which the addition of a security interest to an existing obligation is rescindable. The revised comment makes clear that if a security interest in the consumer's principal dwelling is added to a transaction that was previously exempt from the regulation (because it was credit over $25,000 not secured by real property or a principal dwelling), the consumer has the right to rescind the addition of that security interest even if the existing obligation is not satisfied and replaced by a new obligation. Finally, the term "preexisting" has been replaced by "existing" for consistency of terminology.

23(c) Delay of Creditor's Performance--Comment 23(c)-3 is 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. In addition, the caption "Permissible actions" has been changed to "Actions during the delay period" to reflect a more neutral statement of the subject of the comment. These revisions were prompted by the fact that some creditors mistakenly believed that the regulation authorized the accrual of finance charges during the rescission period, even if state law prohibited such a practice. The revisions make it clear that the regulation neither authorizes nor prohibits the listed actions.

23(f) Exempt Transactions--In December, the Board adopted an amendment to Regulation Z to redefine what constitutes a new advance of money to a consumer for purposes of the rescission exemption for refinancings with the original creditor. Under the amendment, a new advance of money to a consumer would no longer include amounts attributed solely to the costs of the refinancing. Comment 23(f)-4 has been changed to incorporate the revised definition of a new advance of money in a refinancing with the original creditor

and to further explain what amounts are included and excluded when determining what constitutes a new advance. In a refinancing, if the new "amount financed" exceeds the unpaid principal balance, any earned unpaid finance charges on the existing debt, and the amounts attributable solely to the costs of the refinancing, the consumer has the right of rescission as to the difference. Final comment 23(f)-4 differs from the proposal in that it explains that in determining whether there is a new advance in a refinancing, creditors may rely on the information stated in the latest Truth in Lending disclosure given to the consumer. Thus, for example, if the actual dollar amount of refinancing costs determined at the time a loan closes differs from that reflected in the latest Truth in Lending disclosure, the creditor may rely on the amounts contained in the disclosure in determining whether there is a new advance in the refinancing. A minor editorial change has also been made in the first sentence of this comment to clarify that a consolidation is a type of refinancing: no substantive change is intended.

Appendix D--Multiple-Advance Construction Loans

Comment Appendix D-5 is 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 final comment provides that regardless of the amount of the interest reserve, it is not treated as a prepaid finance charge. The comment explains that if the consumer is permitted to make interest payments as they become due, the interest reserve should be disregarded in the disclosures and calculations under appendix D. The comment also provides, however, that if a creditor automatically deducts the interest payments from the interest reserve rather than allow the consumer to make the interest payments as they become due, the estimated interest must reflect the fact that interest will accrue on the interest payments as well as the other loan proceeds. The comment explains how to account for that accrual.

List of Subjects in 12 CFR Part 226

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

Pursuant to authority granted in section 105 of the Truth in Lending Act (15 U.S.C. 1604 as amended), the Board amends the official staff commentary to Regulation Z (12 CFR Part 226 Supp. I) as follows:

1. Authority Citation

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.).

PART 226--[AMENDED]

2. Text of Revisions

The commentary (TIL-1, Supplement I to 12 CFR Part 226) is amended by revising comments 2(a)(20)-4, 3(b)-2, 3(b)-3, and 4(c)(4)-1; by adding comment 4(c)(4)-2; by revising the first

sentence of comment 5(b)(1)-1; by revising the third bulleted paragraph and removing the fourth bulleted paragraph of comment 6(b)-1; by adding a new bulleted paragraph at the end of comment 6(b)- 2; by revising comment 6(c)-2; by adding parenthetical material at the end of comment 6(c)-4; by adding new comment 7(f)-8; by adding a new second sentence to comment 7(h)-1; by revising comment 12(d)(2)-1; by adding two new sentences at the end of comment 15(c)-1; by revising the heading and second sentence of comment 15(c)-3; by revising comments 18(g)(2)-1, 18(m)-2, 20(a)(2)-1; by adding comment 20(a)(2)-2; by revising comments 23(a)(1)-5, 23(c)-3, and 23(f)-4; and by adding comment app. D-5, to read as follows:

Supplement I--Official Staff Interpretations

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 a finance charge is not normally imposed, provided the creditor has the right, under the plan, to impose a finance charge from time to time on the outstanding balance. For example, in some plans, such as certain "china club" plans, a finance charge is not imposed if the consumer pays all or a specified portion of the outstanding balance within a given time period. Such a plan could meet the finance charge criterion, if the creditor has the right to impose a finance charge, 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 full 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 additional 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 in personal property used or expected to be used as the consumer's principal dwelling, the plan would no longer be exempt. The creditor must comply with all of the requirements of the regulation including, for example, providing the consumer with an initial disclosure statement. If the security interest being added is in the consumer's principal dwelling, the creditor must also give the consumer the right to rescind the security interest. (See

the commentary to § 226.15 concerning the right of rescission.)
3. Closed-end credit--subsequent changes. A closed-end loan for over $25,000 may later be rewritten for $25,000 or less, or a security interest in real property or in 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 § 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--periodic basis. The participation fees mentioned in § 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; 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 participation fee.
2. Participation fees--exclusions. Minimum monthly charges, charges for non-use of a credit card, and other charges based on either account activity or the amount of credit available under the plan are not excluded from the finance charge by § 226.4(c)(4). Thus, for example, a fee that is charged and then refunded to the consumer based on the extent to which the consumer uses the credit available would be a finance charge. (See the commentary to § 226.4(b)(2).)

Subpart B--Open-End Credit

Section 226.5--General Disclosure Requirements

5(b) Time of Disclosures--5(b)(1) Initial Disclosures

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, the initial disclosures must be given before the consumer makes the first purchase, receives the first advance, or pays any fees or charges under the plan other than an application fee or refundable membership fee (see below).

Section 226.6--Initial Disclosure Statement

6(b) Other Charges

1. General; examples of other charges. Under § 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,

appraisal, and credit report fees (See § 226.4(c)(7))
2. Exclusions. The following are examples of charges that are not "other charges":
- Taxes and filing or notary fees excluded from the finance charge under § 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." (Creditors should be aware, however, that the federal credit practices rules, as well as some state laws, prohibit certain security interests in household goods.) The creditor may, at its option, provide a more specific identification (for example, a model and serial number).

4. Additional collateral. (See comment 6(c)-2.)

Section 226.7--Periodic Statement

7(f) Amount of Finance Charge

8. Start-up fees. Points, loan fees, and similar finance 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 as part of the finance charge on the first periodic statement. However, they need not be factored into the annual percentage rate. (See footnote 33 in the regulation.)

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. Similarly, "closing costs" or "settlement costs," for example, 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), if the same term (such as "closing costs") was used in the initial disclosures and if the creditor chose to itemize and individually disclose the costs included in that term. (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. The security interest must not be the functional equivalent of a right of offset; as a result, routinely including in agreements contract language indicating that consumers are giving a security interest in any deposit accounts maintained with the issuer does not result in a security interest that falls within the 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:
- The consumer must be aware that granting a security interest is a condition

for the credit card account (or for more favorable account terms) 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
- The security interest must be obtainable and enforceable by creditors generally. If other creditors could not obtain a security interest in the consumer's deposit accounts to the same extent as the card issuer, the security interest is prohibited by § 226.12(d)(2).

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, the 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 actions that may be taken during the delay period.)

3. Actions during the delay period. 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 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 the amount of the scheduled payments, reflecting the continual decrease or increase in the premium due. In addition, in transactions where payments vary because interest and principal are paid at different intervals, 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 with fixed quarterly principal payments and monthly interest payments based on the outstanding principal balance, the amount of the interest payments will

change quarterly as principal declines. In such cases the creditor may treat the interest and principal payments as two separate series of payments, separately disclosing the number, amount, and due dates of principal payments, and, using the abbreviated payment schedule, the number, amount, and due dates of 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 "motor vehicles," "securities," "certain household items," or "household goods." (Creditors should be aware, however, that the federal credit practices rules, as well as some state laws, prohibit certain security interests in household goods.) 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. 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 in a consumer's principal dwelling to an existing obligation is rescindable even if the existing obligation is not satisfied and replaced by a new obligation, and even if the existing obligation was previously exempt (because it was credit over $25,000 not secured by real property or a consumer's principal dwelling). 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.

23(c) Delay of Creditor's Performance

3. Actions during the delay period. 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 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.

23(f) Exempt Transactions

4. New advances. The exemption in § 226.23(f)(2) applies only to refinancings (including consolidations) by the original creditor. If the refinancing involves a new advance of money, the amount of the new advance is rescindable. In determining whether there is a new advance, a creditor may rely on the amount financed, refinancing costs, and other figures stated in the latest Truth in Lending disclosures provided to the consumer and is not required to use, for example, more precise information that may only become available when the loan is closed. For purposes of the right of rescission, a new advance does not include amounts attributed solely to the costs of the refinancing. These amounts would include § 226.4(c)(7) charges (such as attorneys fees and title examination and insurance fees, if bona fide and reasonable in amount), as well as insurance premiums and other charges that are not finance charges. (Finance charges on the new transaction--points, for example--would not be considered in determining whether there is a new advance of money in a refinancing since finance charges are not part of the amount financed.) To illustrate, if the sum of the outstanding principal balance plus the earned unpaid finance charge is $50,000 and the new amount financed is $51,000, then the refinancing would be exempt if the extra $1,000 is attributed solely to costs financed in connection with the refinancing that are not finance charges. Of course, if new advances of money are made (for example, to pay for home improvements) and the consumer exercises the right of rescission, the consumer must be placed in the same position as he or she was in prior to entering into the new credit transaction. Thus, all amounts of money (which would include all the costs of the refinancing) already paid by the consumer to the creditor or to a third party as part of the refinancing would have to be refunded to the consumer. (See the commentary to § 226.23(d)(2) for a discussion of refunds to consumers.) A model rescission notice applicable to transactions involving new advances appears in Appendix H.

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. An interest reserve is not treated as a prepaid finance charge, whether the interest reserve is the same as or different from the estimated interest figure calculated under Appendix D.
- If a creditor permits a consumer to make interest payments as they become

due, the interest reserve should be disregarded in the disclosures and calculations under Appendix D.
- If a creditor requires the establishment of an interest reserve and automatically deducts interest payments from the reserve amount rather than allow the consumer to make interest payments as they become due, the fact that interest will accrue on those interest payments as well as the other loan proceeds must be reflected in the calculations and disclosures. To reflect the effects of such compounding, a creditor should first calculate interest on the commitment amount (exclusive of the interest reserve) and then add the figure obtained by assuming that one-half of that interest is outstanding at the contract interest rate for the entire construction period. For example, using the example shown under paragraph A, part I 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, March 31, 1987.

William W. Wiles,

Secretary of the Board.