46 F.R. 51920

PROPOSED RULES

FEDERAL RESERVE SYSTEM

12 CFR Part 226

[Reg. Z; Docket No. R-0368]

Definition of Arranger of Credit

Friday, October 23, 1981

***51920** AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Proposed rule.

SUMMARY: The Board is publishing for comment a proposal to amend the definition of "arranger of credit" in revised Regulation Z. The amendment would revise the definition to describe more clearly an arranger of credit. If adopted, the proposed definition would cover many real estate brokers who arrange seller-financed transactions.

DATE: Comments must be received on or before December 7, 1981.

ADDRESS: Comments should refer to Docket No. R-0368 and should be mailed to the Secretary, Board of Governors of the Federal Reserve System, Washington, D.C. 20551, or delivered to Room B-2223, 20th and Constitution Avenue, N.W., Washington, D.C., between 8:45 a.m. and 5:15 p.m. Comments may be inspected weekdays in Room B-1122 between 8:45 a.m. and 5:15 p.m.

FOR FURTHER INFORMATION CONTACT:

Regarding the regulation: Susan Werthan or Steven Zeisel, Staff Attorneys, Division of Consumer and Community Affairs, Board of Governors of the Federal Reserve System, Washington, D.C. 20551 (202) 452-3867. Regarding the regulatory analysis: Fred B. Ruckdeschel, Economist, Regulatory Improvement Project, Board of Governors of the Federal Reserve System, Washington, D.C. 20551 (202) 452-2579.

SUPPLEMENTARY INFORMATION:

(1) Introduction

Effective April 1, 1981, the Board substantially revised Regulation Z, which implements the Truth in Lending Act (46 FR 20848, April 7, 1981). The revisions reflected amendments made by the Truth in Lending Simplification and Reform Act (Title VI of the Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. 96-221). Creditors may begin complying with the revised regulation immediately, but compliance does not become mandatory until April 1, 1982. The Board is now publishing for comment a proposed amendment to the definition of arranger of credit in the revised regulation; unless otherwise indicated, all references to Regulation Z are to the revised regulation.

The Truth in Lending Act requires that "creditors" give Truth in Lending disclosures to consumers. A creditor is defined as a person who regularly extends consumer credit, or a person who is an "arranger of credit."

Under the previous Truth in Lending Act, an arranger of credit was considered a creditor only if the person actually extending the credit was also a creditor (one who in the ordinary course of business regularly extends consumer credit). The Truth in Lending Simplification and Reform Act changed the definition of "creditor"

to cover instead those arrangers who regularly arrange for credit to be extended by persons who do not meet the creditor definition. This change eliminated coverage of those who arrange credit on behalf of creditors, but for the first time covered those who arrange credit for non-creditors. The simplification act does not make clear, however, what activities constitute arranging credit, and Regulation Z does not significantly expand the statutory definition.

The Board believes that more specificity is needed to make the definition easier to apply to individual cases and to assist persons, such as real estate brokers, to determine whether they must comply with Regulation Z. Therefore, the proposed definition attempts to describe more precisely what actions constitute arranging for credit.

Regulation Z presently defines an arranger of credit as follows:

"Arranger of credit" means a person who regularly arranges for the extension of consumer credit 2 by another person if:

(i) A finance charge may be imposed for that credit, or the credit is payable by written agreement in more than four installments (not including a downpayment); and

(ii) The person extending the credit is not a creditor.

The footnote explains that a person regularly arranges for the extension of consumer credit only if it arranged credit more than 25 times (or more than 5 times for transactions secured by a dwelling) in the preceding calendar year.

The proposal would retain the substance of the present definition but it would add 2 factors to clarify the meaning of the word "arrange." To fall within the proposed definition, a person must be involved in (1) developing or negotiating credit terms and (2) helping to complete the credit documents (the sale contract would be a credit document for this purpose if it spells out terms upon which the seller agrees to provide financing for the buyer). The definition would cover most mortgage loan brokers, as well as real estate brokers arranging seller-financed transactions.

The mortgage loan broker typically advertises the availability of loans and is approached by a potential borrower. The borrower completes an application, and a mortgage or deed of trust is drafted based on the terms offered by the broker and the particular needs of the borrower. The broker then obtains a lender--often a private individual who desires to invest funds in the mortgage market. Since the mortgage loan broker typically develops the credit terms and assists in completing the relevant credit documents, the broker would be an arranger of credit under the proposed definition (assuming the arranger definition is met in other respects).

The proposed definition would also cover most real estate brokers who arrange sales involving seller financing. In this increasingly common situation, the buyer often assumes an existing mortgage and the seller finances a second mortgage loan for the difference between the sale price and the existing mortgage (less any downpayment). Alternatively, the owner may take back a first mortgage for the entire sale price (less any downpayment). The real estate broker or salesperson typically acts as an intermediary, suggesting or proposing the terms that the owner may be willing to accept and the terms that the buyer is willing to offer. The terms are usually drafted on purchase agreement form supplied by the broker and prepared with the broker's aid. In such a situation, the broker would be an arranger of credit (if the proposed definition is ***51921** otherwise met) since the broker negotiates the credit terms and assists in completing credit documents.

If the real estate broker or salesperson does no more than suggest that the seller supply a portion of the financing, the broker would not be an arranger of credit. Likewise, if the broker assists in completing the contract documents, but does not develop or negotiate the terms, the broker would not be an arranger.

While the Board believes that the proposed language sufficiently describes what it means to arrange credit, various interpretations of the proposed language are

possible. The Board solicits comment on the following points:

What activities should constitute developing or negotiating the credit terms

Should "credit documents" refer only to those documents that contractually obligate the consumer

How should real estate brokers be counted for purposes of the numerical test of coverage--by salesperson, broker or brokerage firm

An entirely different definition than the proposal may be preferred. Some alternative ways of describing what it means to arrange credit are contained in the following list. They could be added to the proposed definition, or they could substitute for it. They all assume that the "arranger" regularly arranges consumer credit to be extended by a person who is not a creditor and that the credit involves a finance charge or is payable by written agreement in more than 4 installments.

Arranging credit might include:

Transmitting or conveying the terms of the offer.

Bringing together the parties in regard to the financing.

Advising the credit extender or consumer regarding the financing terms.

Procuring or soliciting an extender of credit.

Acting as an intermediary between the credit extender and the consumer.

The Board solicits comment on the usefulness of any or all of the characteristics listed as possible additions or alternatives to the definition.

Furthermore, an arranger of credit may or may not receive a fee for the service. The Board solicits comment on whether receipt of a fee should be part of the definition of an arranger of credit. Real estate brokers, who obtain a commission for selling but not an explicit fee for obtaining financing, would be excluded from Truth in Lending requirements by such a test.

Finally, the Board solicits comment on the question of whether real estate brokers who assist in seller financing should be considered arrangers of credit, and thereby have responsibilities for making Truth in Lending disclosures.

The Board is allowing less than the usual 60 days for comment because it believes that prompt resolution of the matter is in the public interest in view of the impending date for mandatory compliance with the revised regulation.

(2) Initial Regulatory Flexibility Analysis. The Board requests comment on a proposed clarification of the word "arrange," as in "arrange credit," which is undefined in the Truth in Lending Simplification and Reform Act and is employed in the Board's revised Regulation Z, which implements the act.

The clarification is necessary to implement the act as it applies to persons who arrange a credit transaction between a borrowing consumer and a nonprofessional extender of credit, who does not conform to the definition of "creditor" in Regulation Z and is thus not subject to the disclosure requirements of the Truth in Lending Act.

Anyone who, by the regulatory definition, regularly aranges credit would be required to provide a consumer with the standard disclosures required for the type of credit being provided. [FN1]

FN1 An extender or arranger of credit is not required to provide disclosures if he or she extends credit no more than 5 times during the preceding or current calendar year when transactions are secured by a dwelling or more than 25 times in other

instances.

Objective of the proposed definition. The purposes of the Truth in Lending Act and Regulation Z are to assure a meaningful disclosure of credit terms so that the consumers will be able to (1) compare more readily the various credit terms available to them and (2) avoid the uninformed use of credit. The primary objective of the proposed definition is to assure that all meaningful terms of credit are disclosed to buyers of dwellings when a real estate salesperson or broker arranges financing from a nonprofessional creditor, most notably individuals selling their homes. [FN2]

FN2 The Board believes that consumers very rarely obtain credit from nonprofessional creditors through the services of an arranger of credit unless the credit is secured by a dwelling. Moreover, under the regulation an arranger is required to provide disclosures only when he or she arranges credit from nonprofessional lenders more than 25 times per year. The Board seeks information on whether nonprofessional lenders provide, through arrangers, any significant volume of credit that is not secured by a dwelling.

Small entities to which the rule would apply. Although data on the number of firms, brokers, and salespersons in real-estate brokerage are scanty, the proposed definition would directly or indirectly apply to a large number of small entities, including individuals. Salespersons, who are often technically independent contractors associated with a broker, would present the disclosures to buyers and in many cases calculate the required figures. They number in the hundreds of thousands and perhaps considerably more than one million. Brokers, who would be liable under Regulation Z if a disclosure was not made or was erroneous, number in the tens of thousands. There is also a large number of brokerage firms that would in most cases be classed as small businesses. There are, however, some real estate brokerage firms that could be considered large by standards of that industry. [FN3]

FN3 Locally-owned franchises of a nationwide system are considered here to be individual entities and not to be integral parts of a single large entity.

Under the proposed definition of arranging, real estate brokers who "regularly" arranged credit would be required through their salespersons to provide Truth-in-Lending disclosures when consumers financed the purchase of a dwelling with funds secured by the dwelling and obtained from a lender who was not required to provide the disclosures. The lender could thus be either the seller of the dwelling, a relative of the seller or other person brought in by the seller, or an outside third-party brought in by the broker or salesperson. Regulation Z, as revised, defines "regularly" as meaning arranging credit more than five times in a calendar year when the credit is secured by a dwelling.

Requirements for compliance. Regulation Z requires, among other things, disclosure of (1) the annual percentage rate; (2) the finance charge (total interest payments); (3) the amount financed (the loan); (4) total payments (interest and principal); (5) the total sale price, which includes the amount financed, the finance charge, and the downpayment; and (6) the payment schedule, which shows the monthly payments and any unpaid balance at maturity.

Necessary professional skills. The Board believes that the skills required for calculating figures to be disclosed in simple cases of seller financing are comparable to those needed for calculations provided by many agents when assisting buyers understand the implications of financing through financial institutions. In complex cases of seller financing the selling agent may need to rely on a person more experienced in real estate financing, such as the salesperson's supervising broker.

***51922** Significant economic impacts on small entities. The Board recognizes that costs are incurred when Truth-in-Lending disclosures are required. They include the costs of training of salespersons and brokers to make necessary calculations or the outlays for training, equipment, and communications when a centralized service provides an agent with the required figures. Costs of disclosure will likely be

accentuated because of brokers' efforts to avoid the potential liability of erroneous disclosure statements. It also recognizes that there will be costs that are not directly monetary such as the agent's time and effort and the increased complications during the negotiating process.

Another impact of the proposal would be an increase in the risk, incurred by a broker, of a sales agent providing a disclosure that is incorrect in any of its terms. Although brokers would not be liable for errors if they could show "by a preponderance of evidence that the violation was not intentional and resulted from a bona fide error notwithstanding the maintenance of procedures reasonably adopted to avoid any such error," they could incur the legal and other expenses necessary to contest actions of buyers. The statute normally would provide a buyer 1 year in which to bring an action against a broker for an erroneous disclosure. The Board seeks information whether a broker would also be at risk beyond the one-year period if a buyer later raised a Truth-in-Lending violation as a defense in a collection action brought against the buyer by the seller.

The Board likewise seeks information on the extent to which sellers might also be at risk. Buyers might assert, for example, a violation of the act as a defense for not meeting the terms of debt instruments. Accordingly, a defaulting debtor could, at minimum, increase the potential or actual legal expenses of a seller in a default action and conceivably could cause the seller a more extensive loss owing to an error by a salesperson or broker. [FN4] The buyer might use the threat of a legal action to extract from the seller a renegotiated or refinanced loan on terms more favorable than he could obtain without the threat. Is there any evidence suggesting that buyers might be able (1) to use violations by a real estate broker to avoid their full obligations to sellers or (2) to unfairly abuse good-faith sellers

FN4 Subsequent recovery by the seller from the broker might not be easy, especially for a seller who subsequently moved or retired to another state.

Significant alternatives to the proposed rule. Since the proposal may be regarded as having a significant economic impact on a substantial number of small entities, the Board invites comment on significant alternatives, such as the following:

(1) Application of the numerical tests: The Board believes that if the numerical test of 5 transactions involving financing secured by a dwelling is applied to the broker in each real estate office, a large proportion of sales with seller financing would require Regulation Z disclosures. Alternatively, a smaller proportion of transactions would require disclosures if the definition of arranger is applied individually to the broker and each associate broker in an office; and many fewer would require disclosures if the definition is applied individually to salespersons and to brokers when they are selling.

(2) Exemption of real estate brokers from coverage under Regulation Z: Brokers could be exempt on 2 grounds from providing disclosures for seller financing.

(a) Temporary nature of seller financing. The recent increase in and continued use of seller financing is predicated on the economic and financial conditions in the United States during the past 12-24 months. Accordingly, the present cyclically high volume of seller financing is likely to diminish. For this reason, seller financing might be excluded from the definition of arranging at the present time because the current prominence of seller financing may be deemed temporary.

(b) Reliance on standard documents for conveying information. Standard documents used in seller financing (such as the sales agreement, the note, and the deed of trust) typically show the interest rate, the amount financed, the monthly payment, and the maturity, all of which the required Truth-in-Lending disclosures would duplicate. The documents also typically indicate the fact on an unpaid balance at maturity. They typically do not show the finance charge, the total payments, "total sale price," and notably, the amount of any unpaid balance at maturity, the ballon payment.

Of the 4 disclosure elements not typically shown in the standard documents, the amount of the balloon payments, which is a prominent element in seller financing, is potentially most important to the decision of purchasing a home. Accordingly, requiring disclosure of the ballon payment, in particular, in seller financing would allow for a more informed use of credit if the buyer would not otherwise have learned the amount of unpaid balance and considered that amount in his decision whether to purchase a dwelling.

Stating the amount of an unpaid balance to be paid or refinanced at maturity, however, provides no direct warning of the perceived primary problem in short-term seller financing. Specifically, it does not warn the buyer that economic and financial conditions at maturity could prevent refinancing or could increase its cost above that of the original seller financing to such an extent that the buyer could not afford the monthly payments owed on refinancing. The Board is seeking evidence to indicate whether requiring disclosure of the amount of the balloon payment will be an effective method of alerting a consumer to the kind of financial risk inherent in a balloon payment. For example, is there evidence that Truth-in-Lending disclosures provided by financial institutions have effectively alerted buyers in the past to the current problems with balloon payments

(3) Establishment of different disclosure requirements: In view of the difficulties faced by small entities, only those disclosures considered vitally important might be required of real estate brokers rather than making coverage under Regulation Z an all or nothing proposition for brokers. On the other hand, the primary burdens may arise from the requirement to disclose at all rather than from the number of items that must be disclosed.

(4) Provision for a different effective date: The requirements of the act could be delayed from April 1, 1982, until October 1, 1982, for real estate brokerage firms. Most of the firms are small and would be subject to the disclosure requirements of Regulation Z for the first time. The delay might allow the real estate industry time to fully investigate and resolve potential problems associated with the "arranger" issue. Moreover, a delay might allow the industry to adjust more easily to the regulatory burden while the difficult conditions in the real estate market persist. On the other hand, a different effective date would delay full implementation of the simplification act more than 2 years after its passage.

PART 226--TRUTH IN LENDING

In consideration of the foregoing and pursuant to the authority granted in section 105 of the Truth in Lending Act (15 U.S.C. 1604, as amended), the Board proposes to amend Regulation Z, 46 FR 20848, by revising § 226.2(a)(3) and footnote 2 to read as follows:

***51923** § 226.2 Definitions and rules of construction.

(a) Defnintions. * * *

(a)(3) "Arranger of credit" means a person who regularly [FN5] N

FN5 Regularly means more than 25 times (or more than 5 times for transactions secured by a dwelling) in the preceding calendar year. If a person did not meet these numerical standards in the preceding calendar year, the numbeical standards shall be applied to the current calendar year.

(a)(3)(i) Develops or negotiates the credit terms, and

(a)(3)(ii) Assists in completing credit documents containing the binding credit terms, such as the contract of sale or note.

The credit involved must be extended by person who is not a creditor; and it must be subject to a finance charge or payable by written agreement in more than four installments (not including a downpayment).

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Board of Governors of the Federal Reserve System, October 19, 1981.

Williams W. Wiles,

Secretary of the Board.

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