50 F.R. 20221

PROPOSED RULES

FEDERAL RESERVE SYSTEM

12 CFR Part 226

[Reg. Z; Docket No. R-0545]

Truth in Lending; Variable Rate Disclosure Under Regulation Z

Wednesday, May 15, 1985

***20221** AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Proposed rule.

SUMMARY: The Board is publishing for comment a proposed amendment to Regulation Z (Truth in Lending) that would require creditors to provide more information to consumers about the variable rate feature of adjustable rate mortgages than is currently required under Regulation Z. It would require creditors to make available to consumers descriptive material about adjustable rate mortgages, and to provide a more detailed description of the variable rate feature, along with an example, at the time other Truth in Lending disclosures are given. The proposal would also eliminate a provision of Regulation Z that currently permits creditors to substitute the disclosure required by other federal regulations for the variable rate disclosure required by Regulation Z. These revisions are intended to address concerns regarding the adequacy of information given to consumers entering into adjustable rate mortgage and regarding the burden to creditors of duplicative federal regulations.

DATE: Comments must be received on or before July 12, 1985.

ADDRESS: Comments should be mailed to William W. Wiles, Secretary, Board of Governors of the Federal Reserve ***20222** System, Washington, D.C. 20551, or delivered to the C Street entrance, 20th and C Streets, NW., Washington, D.C. between 8:45 a.m. and 5:15 p.m.   Comments should include reference to Doc. No. R-0545. Comments may be inspected in Room B-1122 between 8:45 a.m. and 5:15 p.m.

FOR FURTHER INFORMATION CONTACT: Regarding the proposed regulatory amendments, Susan Werthan or Steven Zeisel, Senior Attorneys, Division of Consumer and Community Affairs, Board of Governors of the Federal Reserve System, Washington, D.C. 20551 at (202) 452-3867; regarding the regulatory flexibility analysis, Glenn Canner, Director, Micro-Consumer Projects, Division of Research and Statistics, Board of Governors of the Federal Reserve System, Washington, D.C. 20551 at (202) 452-2910; or Joy W. O'Connel, TDD at (202) 452-3244.

SUPPLEMENTARY INFORMATION:

(1) Background

The introduction of variable rate lending has been one of the most significant developments in the credit industry since the enactment of the Truth in Lending Act in 1968.   Traditionally, lenders and consumers agreed on a specific interest rate which then remained fixed for the entire term of the transaction.   In recent years, in order to shift part of the risk of interest rate fluctuations to the consumer, lenders have increasingly turned from fixed to variable rates, particularly in the mortgage industry, where adjustable rate mortgages (ARMs) now account for a significant portion of all mortgages outstanding.   A recent survey conducted by the National Association of Realtors indicates, for example, that in October 1984 over one-third of all first mortgage orginations were ARMs.

The Truth in Lending Act itself has never called for disclosure of a variable rate feature, but Regulation Z has since 1977 required creditors in all closed-end credit transactions to provide certain minimal information about the feature. This information, reflected in § 226.18(f) of the regulation, includes the circumstances under which the rate may increase (for example, when an index rises), limitations on the increase (periodic and overall interest rate caps), and the effect of an increase (for example, whether it would result in an increase in either the number or the amount of payments). Section 226.18(f) also requires creditors to provide a very brief example of the payment terms that could result from an increase. The example need not be extensive, and need not be based on that particular loan; it requires only that the creditor give some indication in dollars and cents terms of the possible payment effect of a rising rate. When the revised Regulation Z was adopted in 1981 to implement the Truth in Lending Simplification and Reform Act of 1980, the variable rate disclosed was retained, even though it is one of the few disclosures in the regulation not mandated by the act. In retaining the disclosure, however, the Board determined that the information required should be kept brief, in order to carry out the purpose of Truth in Lending simplification to provide concise, clear credit information to consumers.

Three other federal agencies also require disclosure of a variable rate feature for institutions under their jurisdiction. In contrast to Regulation Z, all three call for more extensive, detailed information. These disclosure requirements are imposed as part of these agencies' authority to prescribe substantive limits on the types of ARMs that lenders may offer. The Federal Home Loan Bank requires variable rate disclosures for federally chartered savings and loan associations and also for certain other lenders that wish to market their loans to federally chartered savings and loans (12 CFR 545.33). The Office of the Comptroller of the Currency mandates variable rate disclosures for national banks and other lenders that seek to market their loans to national banks (12 CFR Part 29). Under the "Alterative Mortgage Transaction Parity Act of 1982" (12 U.S.C. 3802), state chartered institutions and other mortgage lenders may take advantage of federal authorization of ARMs by following rules of the Bank Board or the Comptroller of the Currency. Most recently, the Department of Housing and Urban Development (HUD) issued its own variable rate disclosure regulations for lenders wishing to participate in the Federal Housing Administration (FHA) insurance program administered by the Department (24 CFR Parts 203 and 234).

The regulations of the three agencies call not only for more extensive information, but for that information to be provided at different points in the loan process than is required by Regulation Z. For example, the disclosures of the Comptroller must be provided at the time the consumer first receives written information about the credit transaction, and all three agencies require lenders to provide information each time the rate changes during the loan term. This is in contrast to Regulation Z, which generally requires that ARM disclosures be provided within three business days after the consumer's written application and requires no subsequent disclosure when the rate changes in accord with the variable rate clause originally disclosed to the consumer.

Regulation Z recognizes the existence of these other disclosure requirements and attempts to alleviate the burden of duplicative disclosures by means of footnote 43 to the regulation. Under this footnote lenders making variable rate disclosures in accordance with one of the three agencies' regulations need not make the variable rate disclosures required by Regulation Z.

Recently, the Board has become concerned that the current regulatory structure, with Regulation Z mandating brief variable rate information and several other regulations calling for more extensive disclosure, may not be fully responding to the needs of either consumers of the mortgage industry. ARMs have become more prevalent and the variety of ARM products must more extensive. This, combined with the potential of ARMs for significant unexpected payment changes, raises questions about the ability of consumers to understand and make informed decisions about ARMs before entering into those transactions. At the same time, the variety of regulatory requirements has proven burdensome to the mortgage industry, particularly when mortgage lenders must satisfy more than one regulation in order to take full advantage of the secondary market. Under certain circumstances, lenders who wish to originate mortgages for possible sale to either a federal savings and loan association or a national bank may have to make disclosures under both agencies' rules.

In the last year, a Congressional subcommittee and the Federal Financial Institutions Examination Council (FFIEC) have addressed the question of the adequacy of current disclosure requirements for ARMs and have made recommendations to the Board. Subcommittee members suggested that the Board amend Regulation Z to require a "worst case" example illustrating the effects of rate increases on payments. They also urged the agencies to work toward uniform disclosure of variable rate features that could be used by all lenders. (In a separate letter, the members of Congress also asked the Board and the Federal Home Loan Bank Board to produce a consumer education pamphlet on ARMs, which was published in February.)

The FFIEC, consisting of representatives from the Board, ***20223** Comptroller of the Currency, Federal Home Loan Bank Board, Federal Deposit Insurance Corporation and National Credit Union Administration, was asked by the Board to consider the questions of uniformity among the agencies and the basis for a " worst case" example of rate increases. Based on the work of a FFIEC task force, which included a representative from HUD, the FFIEC made two major recommendations to the Board. One, consumers should be given information about ARMs before they submit a loan application or pay any fee for the loan. Two, the disclosures should include an explanation of the nature of ARMs and examples reflecting the creditor's ARM program in a rising interest rate environment. In the FFIEC's view, all examples should be based on an assumed 2% increase in each of the first three years of the mortgage.

(2) Proposed amendment

Based on recommendations from the FFIEC and its own analysis, the Board proposes to amend Regulation Z to provide more information to consumers about ARMs and to encourage uniformity of disclosure requirements among the agencies. The amendments would apply only only to transactions secured by the consumer's principal dwelling. This would include all purchase money mortgages, in which the consumer is obtaining a mortgage loan for the purpose of purchasing a home, as well as all transactions in which the consumer is using the home as security for a loan. (Home equity lines, in which an open-end line of credit is secured by the consumer's home, would not be subject to the requirement, which applies only to closed-end mortgages, although the Board is specifically soliciting comment on this aspect of the proposal.) All other consumer credit transactions that contain a variable rate feature would continue to be subject to the current variable rate disclosure requirements in Regulation Z.

The first amendment would add a new paragraph (j) to § 226.17, requiring creditors to make available to consumers information explaining ARMs. The Consumer Handbook on Adjustable Rate Mortgages, developed by the Board and the Federal Home Loan Bank Board, may be used by creditors to fulfill the requirement if they choose. The Board is aware that other organizations such as the Mortgage Bankers Association and the Federal National Mortgage Association have also developed education brochures on ARMs. This material may also satisfy the proposed requirement.

Because the material on ARMs would be available at all times, consumers would have an opportunity to review the information in an unpressured manner before entering into the application process. The information should illustrate, in general terms, the actual financial impact of ARM features, as well as explain important features such as negative amortization and rate and payment caps. This information would serve to alert the consumer to important questions to ask lenders once th shopping process begins.

The second proposed amendment would revise the variable rate disclosure currently required by § 226.18(f) of Regulation Z. Currently, creditors in any variable rate transaction, including mortgages, must provide consumers with abbreviated information regarding the variable rate feature. The information must be provided along with the other Truth in Lending disclosures, that is, for most ARMs within three business days after the creditor's receipt of the consumer's written application.

The content of the variable rate disclosures under the proposed amendment would be significantly expanded from the current regulation. As outlined in the proposed revision to Appendix H-4, detailed, specific information about all major aspects of the variable rate feature would be required to be presented in a clear, concise format. As with the other model forms in Appendix H, however, creditors may delete and disclosures that do not apply to their ARM plans.

The amendment would require creditors to precisely identify the index to which the rate is tied, or provide a brief description of the formula used in calculating the interest rate if no index is used, along with margin or spread over the index. The requirement that the initial rate be stated is intended to alert the consumer to a discount, as well as the term to which that low initial rate would apply. For example, if a creditor discounted a consumer's rate for six months, the disclosure might read, "Your rate is based on the 6- month Treasury Bill rate plus 2%, but your initial rate will be discounted to 9% for six months." The frequency of rate and payment adjustments would be disclosed, along with rate and payment caps. If there are no payment or rate caps, the disclosure would indicate that there are no limits on potential increases in payment or rate. Moreover, if no overall rate caps exist, creditors would be required to make a conspicuous statement to that effect next to the example of payment increases. If the presence of rate or payment caps would result in interest carryover or negative amortization, the disclosure would need to reflect those features with statements substantially similar to those given in the example. Any limits on negative amortization, typically a maximum percentage over the original loan balance, would also be disclosed.

The most significant change in the variable rate disclosure would be the type of example required. Currently, the regulation requires only a very brief example, which need not be transaction-specific. For example, even if a particular loan were for $85,000, the creditor could state, "In $50,000 loan, an increase of 1% at the end of the first year would result in a payment of $800 a month." In contrast, the proposal would require the creditor to show the effects of an increase on the particular loan. Not only must the example be based on that specific loan amount, but the example must reflect the effects of rate or payment caps or other features that would affect the payment schedule. Thus, if the loan calls for payment caps which would result in negative amortization, both the lower earlier payments resulting from the caps and the presumably higher later payments resulting from the increased loan balance must be incorporated into the example.

The proposed example also differs from the current regulation in that it would specify the assumptions about interest rate increases on which the example must be based. Currently, the creditor may select any reasonably representative rate increase assumption in designing its example. Given this flexibility, many creditors have chosen to assume a 1% increase at the end of the first year. In contrast, the proposal would require that the example be based on an assumed increase of 2% in the index rate in each of the first three years during which a rate increase in permitted, with no increases after that point. The effects of the rate increase must then be shown for the full term of the transaction, not merely at a single point in time, as is now permitted by § 226.18(f).

To highlight the potential effect of a variable rate feature, the amendment calls for the increased-rate example to be shown alongside the payments that would result if there were no change in rates for the term of the loan. This payment schedule would be the same as the amounts disclosed under § 226.18(g); a proposed amendment to that paragraph would allow creditors to use the "no change" example as the payment schedule disclosure.

***20224** While the example called for by the proposal is not necessarily the "worst" increase that could occur in individual transactions, the Board believes that specifying a 2% rising-rate scenario has advantages. First, the proposal reflects the recommendation of the FFIEC as to the proper basis for a "worst case" example, and adopting its recommendation may help to foster uniform disclosures among the agencies. Second, an example showing 2% increases for three years would parallel examples that consumers would have gotten earlier if the received the Consumer Handbook. Third, specifying a particular basis for the example resolves the question of the proper basis where there are no limits on rate increases and thus no worst case example is possible.

The proposal also includes an amendment to footnote 38 to § 226.17(a). This amendment would require creditors to give all variable rate disclosures as part of the other segregated Truth in Lending disclosures, by removing the phrase "the variable rate example under § 226.18(f)(4)." In the Board's view, subjecting the variable rate disclosures to the same format requirements as other disclosures would help to call consumers' attention to the information provided by § 226.18(f).

(3) Comment Requested

The Board solicits comment on all aspects of the proposal, and particularly welcomes comment on the following questions:

1. Should footnote 43 to Regulation Z be retained If the footnote were retained, creditors could continue to utilize the disclosures of other agencies in place of the proposed variable rate disclosure under § 226.18(f). This would alleviate the burden of adjusting to new disclosure requirements for those creditors already using the other agencies' disclosures, and those creditors far outnumber creditors using Regulation Z variable rate disclosures. However, continued availability of footnote 43 would also serve to maintain the status quo of duplicative federal regulations, possibly to the detriment of both consumers and creditors. In the Board's view, uniformity of variable rate disclosures would better serve both consumers and creditors than the current overlapping of federal regulations in this area. While the Board recognizes that other agencies may continue to impose their own disclosure requirements even without footnote 43, the Board believes that the elimination of the footnote could encourage further movement toward uniformity of disclosures.

2. Should the timing of the disclosures be revised; specifically, should disclosures be required earlier than three days after application Disclosure of the information before application would provide consumers with information earlier in the credit shopping process and perhaps facilitate comparison among credit sources before the consumer is in any way committed to a particular loan. On the other hand, the information needed for accurate disclosures is less likely to be available at earlier stages in the application process. For example, a consumer may not qualify for the loan terms or ARM plan originally sought, or may alter the loan amount significantly. Furthermore, the Board questions whether the degree of creditor burden involved in providing disclosures before application is justified by the potential benefit to consumers. Would consumers' ability to comparison shop be significantly enhanced if they received disclosures just before application as opposed to three days later

3. While the Board believes that the proposed example based on assumed 2% increases has advantages, would other examples be preferable

- Should the example be based on the actual worst case as opposed to a specified rate increase, as proposed The Board recognizes that the proposed example cannot be characterized as a "worst case" example in all cases. A true worst case would require the creditor to reflect in the example the most extreme rate increases possible over the life of the mortgage. To illustrate, if a 30-year mortgage included a rate cap of 1% per annual adjustment, but no lifetime cap, the example would have to reflect the payments resulting from a 1% increase occurring in each of the 30 years of the transaction. If a loan had neither lifetime nor per adjustment caps, an alternative would have to be devised if the true "worst case" approach were adopted. For instance, the Board might specify the basis for the example, or require no example but require a prominent statement that the loan contains no limits on possible rate increases.

- Should the Board require, in addition to an example of rate increases, an example showing the effect of rate decreases Because, by their very nature, ARMs have the potential for periods of payments that are lower than the initial amount, should an example showing lower payments be included in the disclosure

4. Should the Board provide additional sample forms for other ARM plans If so, what would be the most useful features to illustrate in sample disclosures For instance, should the Board illustrate ARMs with graduated payments, buydowns, discounts, or other features

5. Should the variable rate disclosures for home equity lines of credit be expanded to track the expanded disclosure requirements for ARMs The Board has excluded home equity lines from coverage because the Board believes that open-end variable rate plans have not been identified with the problems of consumer confusion and duplicative regulations associated with other ARMs. However, the Board seeks comment on the appropriate treatment of home equity lines.

List of Subjects in 12 CFR Part 226

Advertising, Bank, banking, Consumer protection, Credit, Federal Reserve System, Finance, Penalties, Truth in Lending.

(4) Regulatory Flexibility Analysis

The Board's Division of Research and Statistics has prepared a regulatory flexibility analysis. A copy of the analysis may be obtained from Publications Services, Board of Governors of the Federal Reserve System, Washington, D.C. 20551, at (202) 452-3245.

PART 226--[AMENDED]

(5) Text of Proposed Revision

12 CFR Part 226 is amended as follows:

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

Authority: 15 U.S.C. 1604 as amended.

2. Part 226 is revised by removing from footnote 38 to § 226.17 the phrase "the variable rate example under § 226.18(f)(4)," by adding paragraph (j) to § 226.17, by removing footnote 43 to paragraph (f) of § 226.18, by revising paragraph (f) of § 226.18, by revising paragraph (g) of § 226.18, and by revising Appendix H, to read as follows:

Subpart C--Closed-End Credit

§ 226.17 General Disclosure Requirements.

* * * * *

(j) Consumer handbook. (1) A creditor that offers variable rate credit secured by the consumer's principal dwelling shall make available at its place of business a clear and concise description of the nature of the loans offered by the creditor. This disclosure shall be made in terms readily understandable by the layman and shall include a description of all significant loan terms.

***20225** (2) The booklet titled Consumer Handbook on Adjustable Rate Mortgages published by the Board and the Federal Home Loan Bank Board constitutes a disclosure in compliance with the requirements of this paragraph. Other brochures may also be deemed to comply with this paragraph.

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§ 226.18 Content of Disclosures.

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(f) Variable rate. (1) If the annual percentage rate may increase after consummation, the following disclosures, except as provided in paragraph (2):

(i) The circumstances under which the rate may increase.

(ii) Any limitations on the increase.

(iii) The effect of an increase.

(iv) An example of the payment terms that would result from an increase.

(2) If the annual percentage rate may increase after consummation and the transaction is secured by the consumer's principal dwelling, disclosures substantially similar to those contained in Appendix H-4, "Transaction Secured by Consumer's Principal Dwelling," including an example of the payment terms that would result from rate increases of 2 percentage points at the end of each of the first 3 years during which a rate increase is permitted, with no increases for the rest of the term. Inapplicable disclosures may be deleted.

(g) Payment schedule.***

(3) In a transaction subject to paragraph (f)(2) of this section, the creditor may comply with this paragraph by providing the examples required by appendix H-4.

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Appendix H--Closed-End Model Forms and Clauses

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H-4--Variable Rate Model Clauses

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Transaction Secured by Consumer's Principal Dwelling

Your rate is based on (identification of index and margin or formula used). Based on the index, your initial rate will be (initial accrual rate) for (initial term).

Rate Increases

Your rate can change (frequency).

[Your rate cannot increase more than ----% at each adjustment.]

[Your rate cannot increase more than ----% over the term of your loan.]

[There are no limits on increases to your rate.]

Payment Increases

Your payment can change (frequency).

[Your payment cannot increase more than (amount or percentage) at each adjustment.]

[There are no limits on increases to your payment.]

[If any of your payments are not sufficient to cover the interest due, the difference will be added to your loan amount. Your loan amount cannot increase by more than ----%.]

[If an interest rate increase is foregone because of a rate cap, it may be imposed at a later time.]

The examples below show how your monthly payments might change depending on future changes in the index rate or formula used to calculate your interest. These are only illustrations to show the possible effects of rate changes--no one can actually predict what rates will do in the future. An increase would make your future payments higher while a decrease could make them lower than they are now. The first example below shows what your payments will be if the index rate [or formula] stays the same. The second example shows what your payments will be if your index rate [or formula] goes up 2% in each of the first three years during which rate increases are permitted, with no increases for the rest of the term. [The examples also show the effect of rate or payment caps on your payments.] [HOWEVER, THERE IS NO CAP ON TOTAL INCREASES TO YOUR INTEREST RATE DURING YOUR LOAN TERM.]

Year	Monthly payment if no change in rate	Monthly payment if rate increases 2 percent in first 3 years

Example Based on $100,000 Loan for 30 Years

Your rate is based on the 6-month Treasury bill rate plus 3%. Based on the index, your initial rate will be 13% for one year.

Rate Increases

Your rate can change yearly.

Your rate cannot increase more than 2% at each adjustment, but there are no limits on overall increases to your rate.

Payment Increases

Your payment can change yearly.

There are no limits on increases to your payments.

If an interest rate increase is foregone because of a rate cap, it may be imposed at a later time.

The examples below show how your monthly payments might change depending on future changes in the index rate or formula used to calculate your interest. However, these are only illustrations to show the possible effects of rate changes--no one can actually predict what rates will do in the future. An increase in the rate would make your future payments higher while a decrease could make them lower than they are now. The first example below shows what your payments will be if the index rate stays the same. The second example shows what your payments will be if your index rate goes up 2% in each of the first three years of the loan with no increases for the rest of the term. HOWEVER, THERE IS NO CAP ON TOTAL INCREASES TO YOUR INTEREST RATE DURING YOUR LOAN TERM.

Year	Monthly payment if no change in rate	Monthly payment if rate increases 2 percent in first 3 years
1	$1106.20	$1106.20
2	1106.20	1263.11
3	1106.20	1422.08
4-30	1106.20	1582.47

By order of the Board of Governors of the Federal Reserve System, May 9, 1985.

William W. Wiles,

Secretary of the Board.

[FR Doc. 85-11644 Filed 5-14-85; 8:45 am]