Dated: September 13, 1990.

Robert C. Keeney,

Deputy Director, Fruit and Vegetable Division.

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FEDERAL RESERVE SYSTEM

12 CFR Part 226

[Regulation Z; Docket No. R-0687]

Truth in Lending; Home Equity Disclosure and Substantive Rule

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final rule.

SUMMARY: The Board is revising Regulation Z (Truth in Lending) to require that creditors wishing to freeze the credit line when the rate cap on a home equity line is reached must expressly provide for this event in their agreements. Creditors that currently include such a provision in their contracts will not be affected by this revision. The Board also is removing from the regulation the provision that would permit delaying the time for providing disclosures about any repayment phase set forth in an agreement. The rules in question relate to the Home Equity Loan Consumer Protection Act of 1988, which requires creditors to provide consumers with information for open-end credit plans secured by the consumer's dwelling, and imposes substantive limitations on these plans. Although the final regulations implementing the law were adopted in June 1989 and became effective in November 1989, in response to litigation, the Board in March 1990 published for comment a proposal dealing with the rate cap provision and the timing of disclosures for the repayment phase.

EFFECTIVE DATE: September 19, 1990, but compliance is optional until October 1, 1991.

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

SUPPLEMENTARY INFORMATION:

Background

The Home Equity Loan Consumer Protection Act was enacted in November 1988. On January 23, 1989, the Board published for comment a proposed rule to implement the statute (54 FR 3063) and on June 9, 1989, adopted a final rule (54 FR 24670). Compliance with the regulation was mandatory as of November 7, 1989.

On November 1, 1989, Consumers Union filed suit against the Board challenging certain aspects of the regulation. *Consumers Union* v. *Federal Reserve Board*, No. 89-3008 (U.S. District Court for the District of Columbia). Among other issues, Consumers Union challenged the provision in the regulation permitting creditors to suspend advances of credit during any period the rate cap is reached. Consumers Union also challenged the part of the regulation permitting creditors to give disclosures about any "repayment" period (that is, when advances are no longer made and the consumer is paying off the amount borrowed) at the time the repayment period begins, rather than at the time of application.

On March 21, 1990, the Board published a proposed rule to amend the regulation relating to the rate cap and delayed timing issues (55 FR 10465). The Board received over 200 comments on the proposal. Based on a review of the comments and further analysis the Board is revising the regulation.

The District Court issued a decision in favor of the Board on May 2, 1990, with regard to other challenged parts of the regulation, but in light of the Board's proposal deferred rendering a decision on the rate cap and delayed timing issues.

Amendments to Regulation Z

(i) Rate Cap Provision

Under section 137(c)(1) of the act, creditors are generally prohibited from unilaterally changing the terms of the plan after the account has been opened. Section 137(c)(2) sets forth certain circumstances in which the creditor may prohibit additional extensions of credit or reduce the credit limit for a plan.

Pursuant to the statute, the final regulation issued by the Board in June 1989 contains substantive limitations on the way home equity plans may be structured. The regulation incorporates the exceptions in section 137(c)(2) of the act limiting the ability of a creditor to change the terms of a plan after the account has been opened. The regulation adds an exception under which a creditor can freeze a line of credit or reduce the credit limit if the rate cap is reached. (Under section 105 of the Truth in Lending Act, the Board is authorized to provide for adjustments and exceptions for transactions that the Board believes are necessary or proper to effectuate the act, prevent circumvention or evasion, or facilitate compliance.) As issued, § 226.5b(f)(3)(vi)(G) permits a creditor to suspend additional advances or reduce the credit limit during any period in which the index value plus margin (the APR corresponding to the periodic rate) reaches the maximum APR (lifetime "cap") provided for in the agreement.[1] If the index and margin drop below the cap, credit privileges must be reinstated.

The regulation does not expressly require that the contract (as opposed to the disclosures) state that a creditor has the right to freeze a line of credit if the rate cap is reached. Creditors are specifically required to disclose if they retain the ability to freeze a line when the rate cap is reached, and this disclosure duty may be met by including it in the agreement. As a practical matter, the Board believes that creditors who wish to preserve this right do include the provision in their contracts.

In March 1990, the Board requested additional comment on whether to amend the regulation to prohibit lenders from freezing a line of credit if the rate cap is reached (as well as a second issue concerning the timing of disclosures about the repayment phase). Nearly all of the more than two hundred commenters on the proposal argued that the Board should permit lenders to freeze the line if the rate cap is reached.

The Board is retaining the provision that permits lenders to freeze a line of credit or reduce the credit limit if the rate cap is reached, but is adopting a technical amendment requiring creditors to include this event in their contracts.

Based on a review of the comment letters, the Board believes removal of this provision from the regulation could cause consumers to suffer adverse consequences such as the imposition of a higher rate cap and the shortening of the draw period for home equity plans. The Board believes that if creditors were prevented from stopping advances once the rate cap is reached, they would seek to maintain their spread and limit interest rate risk by changing the terms on which the credit is offered. A number of commenters stated that lenders would raise their rate cap, for example, from 18% to 24%, if they were required to make advances even if the cap were reached. In such a circumstance—

[1] Section 226.30 of the regulation, which implements section 1204 of the Competitive Equality Banking Act of 1987, requires creditors to include a maximum rate cap in their agreements for all variable-rate plans secured by a consumer's dwelling.

should the index value and margin rise to the cap—24%, rather than 18%, would apply to the entire outstanding balance. This could lead to the possibility of consumers facing higher periodic payments, or payments that pay off less principal. This could in turn result in greater debt problems or overextension. The Board also is mindful of the concern expressed by commenters that interest rate arbitrage could occur if lenders were required to loan funds if the cap is reached. In such a circumstance, lenders might be required to permit advances at below-market rates.

The Board believes that consumers who wish to ensure the ability to borrow funds without interruption, regardless of the rate charged, could negotiate a higher rate cap from the lender before entering into the plan. It is also worth recognizing that any inconvenience to consumers is minimized since the freeze is temporary and in effect only so long as the index value and margin reach or exceed the cap.

The Board also asked for comment on whether creditors should be required to state in their contracts that the line may be frozen if the rate cap is reached. The Board is amending the regulation to require that creditors so specify in the contract if they wish to retain the right to freeze the line of credit when the rate cap is reached. Many commenters noted that to enforce such a provision under state law, the contract must contain such a provision. In addition, several persons commented that to take advantage of the risk weight requirements relating to home equity lines in the risk-based capital guidelines, their contracts had to contain such a provision. Finally, creditors are specifically required to disclose this condition, and it appears that this duty is often met by including it in the agreement. Thus, it appears from the letters received on the proposal and other information that lenders already include such a provision in their contracts, and creditors would likely not be required to revise their contracts.

The Board believes amending the regulation to specify this requirement will ensure greater consistency with the legislative history of the act. That history supports the notion that the statute does not prohibit lenders from freezing the line of credit if the rate cap is reached as long as such a provision is in their contracts. In light of the legal challenge, requiring contracts to contain the freeze provision will ensure that this is a bilateral provision and not a unilateral change to the terms of the plan, which is generally prohibited by the statute.

The Board is deleting the rate cap provision in § 226.5b(f)(3)(vi) of the regulation. Section 226.5b(f)(3)(i) is amended to provide that a lender may prohibit additional extensions of credit or reduce the credit limit when the maximum annual percentage rate is reached, as long as that circumstance is set forth in the initial agreement.

The Board also is adopting a technical amendment to § 226.9(c)(3) of the regulation. That section requires creditors to provide a written notice to consumers if the creditor prohibits additional extensions of credit or reduces the credit limit pursuant to § 226.5b(f)(3)(vi). Because the Board is moving the rate cap provision from § 226.5b(f)(3)(vi) to § 226.5b(f)(3)(i), § 226.9(c)(3) is amended to reflect that a notice must be provided if a creditor freezes a line pursuant to § 226.5b(f)(3)(i) or § 226.5b(f)(3)(vi). This change does not alter any duty the creditor has under § 226.9(c)(3).

Sections 226.5b(d)(4)(iii) and 226.6(e)(1) require creditors to disclose the conditions that permit freezing or reducing the credit limit. Creditors, of course, must continue to disclose under those sections that they may freeze or reduce the credit limit if the maximum annual percentage rate is reached, if they retain this right. The amendments to the regulation do not alter the duty of creditors to disclose this circumstance. The Board will propose changes to comment 5b(d)(4)(iii)–1 and other provisions as needed to clarify this duty, when proposed amendments to the Official Staff Commentary are issued in the fall of 1990.

(ii) Delayed Timing Provision

Some home equity plans provide in the initial agreement for two distinct phases: A "draw" period during which advances may be taken and a "repayment" period during which the balance is paid off and no new funds are advanced. Under the regulation, creditors are required to provide complete disclosures about both the draw and the repayment phases of the plan.

In the supplemental information accompanying the final rule issued in June 1989, the Board stated that while full disclosure about the repayment phase must be provided, creditors have a choice with regard to when those disclosures must be given. Creditors can either provide the information at the time the other disclosures are given (that is, with the application) or defer the bulk of the disclosures until the repayment phase begins. A sample form, G–14C, was provided in the appendix to the regulation for creditors using the second alternative. The Board also stated that, even if a creditor chooses to give the bulk of the repayment disclosures at conversion, the basic information about the repayment phase—such as its length and how the minimum payment will be figures—must be provided with the other application disclosures.

In March 1990, the Board solicited comment on whether the regulation should be amended to require creditors to provide all of the disclosures about the repayment phase with the application, rather than allowing some to be delayed until the time of conversion. The Board is requiring that all disclosures be given at application, and eliminating sample form G–14C, which provides guidance to creditors that delay giving certain disclosures about the repayment phase.

The more flexible approach adopted in the final rule in June 1989 was premised on the notion that consumers might benefit by receiving disclosures later, and that creditors also would benefit by having options about when to provide the disclosures. The comment letters clearly show that creditors are not using this provision, and that consumers may be harmed by not receiving information early. Thus, the policies supporting the original rule are less persuasive. While consumers might benefit from receiving additional information at the later time, there is a strong argument that consumers need to know all the repayment terms early when shopping for a line. The Board also believes a uniform approach would better assist consumers in shopping for a plan and comparing lenders' products. Finally, all evidence indicates that no creditors currently utilize the delayed timing rule—likely due to the greater complexity of preparing two disclosure forms and potential civil liability concerns. The Board is deleting model form G–14C from the regulation, since that is the only provision in the regulation that relates to providing information about the repayment phase later in the plan.

In April 1990 the Board adopted revisions to the Official Staff Commentary relating to home equity lines of credit. In that publication, the Board deferred providing guidance on the issue of delayed disclosures for the repayment phase of a plan though the issue was raised in the proposed commentary issued in November 1989. In light of the Board's decision on this issue, there is no need to address the issue in the Official Staff Commentary.

Effective Date

Section 105(d) of the Truth in Lending Act provides that amendments to Regulation Z shall have an effective date of October 1, and must be promulgated at least six months before that date. Except in the case of complying with the finding of a court or to prevent an unfair or deceptive disclosure practice, the statute does not permit an earlier effective date. Thus, in the present case the Board believes an October 1 effective date is required by the statute. Therefore, the amendments apply to any home equity plan entered into on or after October 1, 1991. Creditors wishing to retain the right to freeze a line of credit if the rate cap is reached must include such a provision in their home equity agreements entered into on or after the effective date. As of October 1, 1991, creditors also must provide complete disclosures about the repayment phase with the other § 226.5b disclosures (given at the time an application form is provided to the consumer), and are not permitted to delay giving disclosures about that phase.

Economic Impact Statement

The changes to the regulation are likely to have an insignificant impact on creditors' costs, including small entities, since available evidence indicates that they currently operate in a manner consistent with the new rule. The Board's Division of Research and Statistics has prepared an economic impact statement on the revisions to Regulation Z. A copy of the analysis may be obtained from Publications Services, Board of Governors of the Federal Reserve System, Washington, DC 20551, at (202) 452-3245.

List of Subjects in 12 CFR Part 226

Advertising; Banks; Banking; Consumer protection; Credit; Federal reserve system; Finance; Penalties; Rate limitations; Truth in lending.

Text of Proposed Revisions

Pursuant to authority granted in section 105 of the Truth in Lending Act (15 U.S.C. 1604 as amended), the Board is amending Regulation Z, 12 CFR part 226, as follows:

PART 226—[AMENDED]

1. The authority citation for part 226 continues to read:

Authority: Section 105, Truth in Lending Act, as amended by sec. 605, Pub. L. No. 96-221, 94 Stat. 170 (15 U.S.C. 1604 et seq.); section 1204(c), Competitive Equality Banking Act, Pub. L. No. 100-86, 101 Stat. 552.

2. In § 226.5b, the introductory text to paragraphs (f), (f)(3), and (f)(3)(vi) is republished and paragraphs (f)(3)(i), (f)(3)(vi)(E), and (f)(3)(vi)(F) are revised and paragraph (f)(3)(vi)(G) is removed to read as follows:

Subpart B—Open-End Credit

§ 226.5b Requirements for home equity plans.

* * * * *

(f) *Limitations on home equity plans.* No creditor may, by contract or otherwise:

* * * * *

(3) Change any term, except that a creditor may:

(i) Provide in the initial agreement that it may prohibit additional extension of credit or reduce the credit limit during any period in which the maximum annual percentage rate is reached. A creditor also may provide in the initial agreement that specified changes will occur if a specified event takes place (for example, that the annual percentage rate will increase a specified amount if the consumer leaves the creditor's employment).

* * * * *

(vi) Prohibit additional extensions of credit or reduce the credit limit applicable to an agreement during any period in which:

* * * * *

(E) The priority of the creditor's security interest is adversely affected by government action to the extent that the value of the security interest is less than 120 percent of the credit line; or

(F) The creditor is notified by its regulatory agency that continued advances constitute an unsafe and unsound practice.

* * * * *

3. In § 226.9, paragraph (c)(3) is revised to read as follows:

§ 226.9 Subsequent disclosure requirements.

* * * * *

(c) *Change in terms.* * * *

(3) *Notice for home equity plans.* If a creditor prohibits additional extensions of credit or reduces the credit limit applicable to a home equity plan pursuant to § 226.5b(f)(3)(i) or § 226.5b(f)(3)(vi), the creditor shall mail or deliver written notice of the action to each consumer who will be affected. The notice must be provided not later than three business days after the actions is taken and shall contain specific reasons for the action. If the creditor requires the consumer to request reinstatement of credit privileges, the notice also shall state that fact.

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Appendix G to Part 226 [Amended]

4. Appendix G to part 226 is amended by removing G-14C—Home Equity Sample (Repayment phase disclosed later).

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By order of the Board of Governors of the Federal Reserve System, September 12, 1990.

William W. Wiles,

Secretary of the Board.

[FR Doc. 90-21974 Filed 9-17-90; 8:45 am]

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FARM CREDIT ADMINISTRATION

12 CFR Part 615

RIN 3052-AA94

Funding and Fiscal Affairs, Loan Policies and Operations, and Funding Operations; Correction

AGENCY: Farm Credit Administration.

ACTION: Final rule; correction.

SUMMARY: The Farm Credit Administration (FCA) is correcting an error that appeared in the final rule that amended the regulation setting forth lending authorities and lending requirements for Farm Credit banks and associations, reconciling, where necessary the authorities of institutions created under the restructuring provisions of the Agricultural Credit Act of 1987. The final rule appeared in the Federal Register on June 19, 1990 (55 FR 24861).

EFFECTIVE DATE: July 30, 1990.

FOR FURTHER INFORMATION CONTACT: Cindy R. Nicholson, Paralegal Specialist, Office of General Counsel, Farm Credit Administration, McLean, Virginia 22102-5090, (703) 883-4020, TDD (703) 883-4444.

SUPPLEMENTARY INFORMATION: In preparing the final rule for publication in the Federal Register, one of the amendatory instructions on page 24887 was incorrectly stated.

PART 615—FUNDING AND FISCAL AFFAIRS, LOAN POLICIES AND OPERATIONS, AND FUNDING OPERATIONS

Subpart E—Investments

1. On page 24887, third column, amendatory instruction #48, the words "revising the heading;" were inadvertently omitted. Amendatory