FEDERAL RESERVE BANK OF CHICAGO
230 SOUTH LA SALLE STREET
CHICAGO, ILLINOIS 60690
(312) 322-5322

Circular No. 2844
October 16, 1980

To the Member and Nonmember Banks
and Others Concerned in the
Seventh Federal Reserve District:

STAFF INTERPRETATION
REGULATION Z, "TRUTH IN LENDING"

The Board of Governors of the Federal Reserve System has issued a staff interpretation effective September 23, 1980, concerning disclosures required under Regulation Z, "Truth in Lending," in the case of renegotiable rate mortgages.

This interpretation will be the Board's rule on this subject until the Board revises its Regulation Z under the Truth in Lending Simplification and Reform Act of 1980. The revision of Regulation Z should be adopted not later than April 1, 1981.

The Board's press release and staff interpretation are enclosed.

Robert P. Mayo

President

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FEDERAL RESERVE press release

The Federal Reserve Board today made public an official staff interpretation concerning disclosures required under Regulation Z -- Truth in Lending -- in the case of renegotiable rate mortgages.

The staff interpretation will be the Board's rule on this subject until the Board adopts formal rules, not later than April 1, 1981, revising Regulation Z under the Truth in Lending Simplification and Reform Act of 1980. The interpretation was adopted following consideration of comment on a proposed interpretation.

The staff interpretation concerns renegotiable rate mortgages that have two essential features: a short term loan secured by a long term mortgage and a lender's obligation to renew the short term loan on the same credit terms except for a change in the interest rate.

In such cases the interpretation permits disclosures either as a variable rate obligation (under Section 226.8(b)(8)) of Regulation Z or as a balloon payment obligation (under Section 226.8(b)(3)) which, if renewed, constitutes a refinancing.

The interpretation concerning these subjects, and others, is attached. It is effective September 23, 1980.

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FEDERAL RESERVE SYSTEM

12 CFR Part 226

[Reg. Z; FC-0172]

TRUTH IN LENDING

Final Official Staff Interpretation

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final official staff interpretation.

SUMMARY: In accordance with 12 CFR 226.1(d)(2)(ii), the Board staff is publishing in final form official staff interpretation FC-0172 of Regulation Z, Truth in Lending, regarding disclosures for renegotiable rate mortgages (RRMs). Because of the unique features of renegotiable rate mortgages, the interpretation permits disclosure either: (1) as a variable rate obligation under § 226.8(b)(8); or (2) as a balloon payment obligation under § 226.8(b)(3), which, if renewed, constitutes a refinancing under § 226.8(j). The agency is taking this action after reviewing the comments received upon publication of the interpretation.

DATE: Effective September 23, 1980.

FOR FURTHER INFORMATION CONTACT: Susan M. Werthan, Staff Attorney, Division of Consumer and Community Affairs, Board of Governors of the Federal Reserve System, Washington, D.C. 20551 (202-452-3867).

SUPPLEMENTARY INFORMATION:

(1) The text of official staff interpretation FC-0172 is published with identifying details deleted to the extent required to prevent a clearly unwarranted invasion of personal privacy. The Board maintains and makes available for public inspection and copying a current index providing identifying information for the public, subject to certain limitations stated in 12 CFR Part 261.6.

(2) The June 19, 1980, version of FC-0172 provided that for Truth in Lending purposes, renegotiable rate mortgages could be disclosed either as variable rate obligations or as balloon payment obligations that are refinanced.

(3) Comment was solicited about the type of disclosure that should be required as an interim measure until the revised Regulation Z is adopted. Comment was also solicited about the type of disclosure that should be required in the revised regulation which must be adopted by April 1, 1981, under the Truth in Lending Simplification and Reform Act of 1980. The comments addressing the issue of which approach to take in the revised regulation will be fully considered in revising Regulation Z.

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Twenty-four comments were received. The majority of the commenters that addressed the interim disclosure issue favored permitting the two options described in the proposed interpretation. Three of the commenters preferred allowing only one type of disclosure, instead of allowing two options until adopting the revised regulation. They asserted that the shopping function of Regulation Z would be thwarted by permitting two options. Many commenters, however, agreed with the proposal's description of the unique features of RRMs and the resulting difficulties in deciding what Truth in Lending disclosures to make.

(4) In light of the comments received and upon further consideration, permitting two options appears to be the best interim position. The following revisions have been made to the text of the interpretation:

(a) The scope of the interpretation has been expanded to include not only mortgages covered by the Federal Home Loan Bank Board regulations of April 3, 1980, but also all mortgages containing two essential features. These features are: (1) a short-term loan secured by a long-term mortgage; and (2) a lender's obligation to renew the short-term loan on the same credit terms, except for a change in rate. Some of the commenters urged that the applicability of the interpretation be broadened, and upon reconsideration it was decided to do so.

(b) The paragraph discussing rescission has been revised in light of the revision described in paragraph (a) above. It explains that the applicability of the right of rescission depends upon both the type of instrument and the type of disclosure made. In particular, since fees may be charged at renewal in certain RRMs, rescission may be applicable.

(c) Paragraph nine clarifies that creditors may refer to the contract interest rate, rather than the annual percentage rate, in making variable rate disclosures. As the staff has stated in earlier letters, creditors are permitted to refer to interest rates when disclosing the limits on rate change and when stating the required hypotheticals (if simple interest rate tables are used in the calculations).

(d) Minor editorial changes were made, as well as changes to reflect the status of the revised Regulation Z. Also, changes have been made to reflect the interpretation's new date and to indicate that it is in final form.

(5) Although not reflected in the text of the letter, it appears necessary to clarify a point raised by several of the commenters about the annual percentage rate calculations in the examples. A calculator, rather than the Board's annual percentage rate tables, was used to determine the APRs. If Volume I of the tables is used, a different result may be reached, especially for the balloon payment loan example; if Volume I is used correctly, creditors are protected from civil liability with regard to the accuracy of the annual percentage rate.

(6) Official staff interpretation FC-0172, as revised, is effective September 23, 1980.

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(7) Authority: 15 U.S.C. 1640(f).

§§ 226.8(b)(3) and 226.8(b)(8) - Renegotiable rate mortgages may be disclosed either as balloon payment mortgages with all disclosures based on the term of the initial loan, or as variable rate mortgages with all disclosures based on the term of the underlying mortgage.

§ 226.8(j) - If renegotiable rate mortgages are disclosed as balloon payment mortgages, refinancing disclosures must be given at each renewal of the loan.

§ 226.9(g) - The right of rescission does not apply to a renegotiable rate mortgage if disclosure is made as a variable rate mortgage, but may apply if disclosure is made as a balloon payment mortgage.

§ 226.903 - The right of rescission does not apply to the renewal of a renegotiable rate mortgage that was disclosed as a balloon payment mortgage if no fees are charged and no new credit is extended.

This is in response to your letter regarding proper disclosures under Regulation Z for renegotiable rate mortgage instruments (RRMs). This letter addresses only mortgage instruments containing two essential characteristics: (1) a short-term loan secured by a long-term mortgage; and (2) a lender's obligation to renew the short-term loan on the same credit terms, except for a change in rate. One example of this type of mortgage is the RRM described in the Federal Home Loan Bank Board (Bank Board) regulations that became effective on April 3, 1980.

The type of transaction described in the Bank Board's regulations is a loan issued for a term of three to five years, secured by a long-term mortgage of up to 30 years. The lender must grant the borrower an option to renew the loan at equal intervals. Unless the borrower pays off the loan at that time, the lender is obligated to renew the loan. At the time of renewal, the lender may adjust the interest rate of the loan, with the change in rate being tied to the monthly national average mortgage rate index, as computed by the Bank Board. However, the interest rate may not increase or decrease by more than one-half of one percentage point (0.5%) per year, with a maximum five percentage point (5%) change over the life of the mortgage. Although the lender must implement interest rate decreases, it need not pass along increases to the borrower.

Your letter raises the issue of whether RRMs should be treated as variable rate mortgages under § 226.8(b)(8) or as mortgages with balloon payments under § 226.8(b)(3).

In the staff's view, RRMs contain features of both long-term variable rate transactions and short-term balloon payment loans. Like variable rate mortgages, RRMs are subject to changes in the annual percentage rate over the long term of the mortgage. In the RRM, the lender must renew each

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short-term loan if the customer fails to pay off the balance. Therefore, the term could be considered to be that of a long-term variable rate mortgage, rather than the short term of a balloon payment loan.

On the other hand, RRMs could be viewed as balloon payment mortgages since each loan has a term of three to five years, with a balloon payment at the end of that term. At the end of each loan term, the customer has the option to refinance the loan with another lender or to accept a renewal of the loan at a different interest rate. When viewed this way, a renewal constitutes a refinancing requiring an entire set of new disclosures for another short-term balloon payment loan.

Since RRMs contain features of both variable rate and balloon payment mortgages, it is the staff's view that at this time disclosure is permissible either: (1) as a variable rate obligation under § 226.8(b)(8); or (2) as a balloon payment obligation under § 226.8(b)(3), which, if renewed, constitutes a refinancing under § 226.8(j).

To illustrate the disclosure of RRMs as variable rate mortgages and as balloon payment mortgages, assume the following example. The loan amount is $100,000 for a three-year initial term with a 30-year mortgage. The interest rate is 15% and the prepaid finance charge equals 2 percent of the loan amount ($2,000). Monthly payments for the initial term are calculated on an assumed amortization period of 30 years.

If this type of mortgage is treated as a variable rate mortgage, the customer receives disclosures only at consummation of the initial loan. Calculation of the annual percentage rate, total finance charge, and payment schedule are based on a 30-year term, at the rate then in effect. Therefore, in this example, the payment schedule would be shown as 360 monthly payments of $1,264, with an annual percentage rate of 15.32%.

Section 226.8(b)(8) requires that additional disclosures be made regarding the variable rate feature. The fact that the annual percentage rate is subject to increase and the conditions under which the rate will increase must be disclosed. As an example, for RRMs under the Bank Board regulations, this includes identification of the Bank Board's monthly national average mortgage rate index as the index to which rate increases are tied, and disclosure of the limitation on interest rate increases of one-half of one percentage point (0.5%) per year, with a maximum of five percentage points (5%) over the life of the mortgage. Section 226.8(b)(8) also requires the lender to state that rate increases would be implemented by increasing the amount of the monthly payment. In addition, the estimated effect on the payment amount of a hypothetical immediate increase in the annual percentage rate of one quarter of one percentage point (0.25%) would have to be disclosed. Note that official staff interpretation FC-0152 permits creditors that calculate the estimated effect on payments by using tables based on simple interest rates, rather than annual percentage rate tables, to state the example in terms of a change in the interest rate, rather than a change in the annual percentage rate.

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If variable rate disclosures are given for RRMs, § 226.8(b)(8) provides that increases in the annual percentage rate are not treated as refinancings, and the customer need not be given new Truth in Lending disclosures at renewal.

If an RRM is treated as a balloon payment mortgage under § 226.8(b)(3), both the timing and the content of the disclosures would differ from that for variable rate mortgages. In the example given above, the term of the transaction would be three years, rather than 30 years, and each renewal of the loan would be considered a refinancing requiring a new set of disclosures under § 226.8(j). The final payment would be labelled as a "balloon payment" under § 226.8(b)(3), with a disclosure that the balloon payment may be refinanced if not paid when due. As Public Information Letter 1200 states, § 226.8(b)(3) does not require disclosure of the terms of the refinancing, although this could be given as additional information under § 226.6(c).

In the example above, all of the disclosures would be based on the three-year loan term. Therefore, disclosures for the initial loan would state that there are 36 monthly payments, 35 of $1,264 and one "balloon payment" of $100,613. The annual percentage rate would be 15.84%. At the time of each renewal, an entire set of new refinancing disclosures would be given based on the new term and the new interest rate.

In the staff's view, there are certain advantages in disclosing RRMs as long-term variable rate mortgages, and other advantages in treating them as short-term balloon payment mortgages. Under the § 226.8(b)(8) variable rate provision, a customer would be informed at consummation of the initial loan about the variable rate feature, and the hypothetical example would give the customer some idea of the possible effect of a rate increase before the customer becomes obligated. Another reason for making variable rate disclosures is that a person undertaking an RRM may in fact view it as a 30-year obligation with periodic adjustments of the rate, particularly in light of the lender's obligation to renew each loan.

On the other hand, balloon payment disclosures would also provide useful information to customers. Although the customer would not receive detailed Truth in Lending information about the rate increases at the time of the initial loan's consummation, the lender would be required to state that there would be a balloon payment and that it could be refinanced at the end of the initial term. Moreover, at the time of each renewal, the customer would be given complete disclosures reflecting the actual changes in rate, payment amount, and so forth. The furnishing of new disclosures at renewal, a time when they may serve a useful shopping function, would also emphasize the fact that the customer can pay off the RRM and refinance with another lender.

The staff wishes to point out that this letter gives lenders two separate options. Lenders may not mix these two types of permitted disclosure. For example, lenders may not disclose a payment schedule based on the short term of the loan (as in balloon payment disclosures), but calculate an annual percentage rate based on the long term of the mortgage (as in variable rate disclosures).

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The application of the right of rescission will depend upon what type of RRM is involved and which disclosure approach is followed. Under either approach, § 226.9(g)(1) exempts the initial transaction from the rescission requirements since a first lien to finance the acquisition of a dwelling is involved. If the variable rate approach is followed, adjustments of the rate do not constitute refinancings, and the right of rescission does not arise. If balloon payment disclosures are used, renewals constitute refinancings, and Board Interpretation § 226.903 determines whether the right of rescission applies. Section 226.903 provides that, where an obligation is refinanced with the original lender, only new credit extended in excess of the unpaid balance plus the accrued and unpaid finance charge is subject to rescission. If a lender charges fees upon renewal, additional credit may be extended, and that portion of the refinancing would be rescindable. If no fees are charged, it appears that rescission would not apply.

In order not to impede the development of RRM programs, disclosure under either § 226.8(b)(8) or §§ 226.8(b)(3) and 226.8(j) is considered acceptable at this time. In addition, it is recognized that RRMs contain features of both variable rate and balloon payment mortgages and that each disclosure scheme has certain advantages.

This letter, however, represents an interim position that will be effective only until the issues can be finally resolved in the revised Regulation Z that will be adopted by April 1, 1981, under the Truth in Lending Simplification and Reform Act. That act was signed into law on March 31, 1980, as Title VI of Public Law 96-221, the Depository Institutions Deregulation and Monetary Control Act. A proposed revision of Regulation Z that implements the act was published for comment on May 5, 1980 (45 FR 29702). The comment period closed on July 31, and the staff is now reviewing the comments.

This is an official staff interpretation of Regulation Z, issued after publication for comment in accordance with § 226.1(d)(2). It is limited to the facts and issues discussed above and will become effective on September 23, 1980.

Sincerely,

Janet Hart
Director

Board of Governors of the Federal Reserve System, September 17, 1980.

(signed) Theodore E. Allison

[SEAL]

Theodore E. Allison
Secretary of the Board

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