APR 3 1986

FEDERAL RESERVE press release

For immediate release April 2, 1986

The Federal Reserve Board has adopted final changes in the official staff commentary on Regulation Z (Truth in Lending). Proposed changes were published by the Board on December 5, 1985.

The revisions to the official staff commentary address such matters as credit transactions that have some lease characteristics, prepayment penalty and security interest disclosure, rules for identifying transactions, and advertising for open-end credit.

The changes to the commentary are attached.

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Attachment

FEDERAL RESERVE SYSTEM

12 CFR Part 226

[Reg. Z; TIL-1]

TRUTH IN LENDING

Official Staff Commentary Update

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.

EFFECTIVE DATE: April 1, 1986, but reliance optional until October 1, 1986.

FOR FURTHER INFORMATION: Contact the following attorneys in the Division of Consumer and Community Affairs, Board of Governors of the Federal Reserve System, Washington, D.C. 20551, at (202) 452-3667 or (202) 452-3867:

Subpart A -- Adrienne Hurt
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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 four general updates so far -- the first in September 1982 (47 FR 41338), the second in April 1983 (48 FR 14882), the third in April 1984 (49 FR 13482), and the fourth in April 1985 (50 FR 13181). There was also a limited update concerning fees for the use of automated teller machines, which was adopted in October 1984 (49 FR 40560). This notice contains the fifth general update, which was proposed for comment on December 12, 1985 (50 FR 50794). The changes are effective on April 1, 1986. 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, 1986, the uniform effective date provided for in § 105(d) of the revised Truth in Lending Act.

Certain conventions have been used to highlight the revisions. New language is shown inside bold-faced arrows, while language that is being deleted is set off with brackets.

(2) Explanation of revisions. Following is a brief description of the revisions to the commentary and how they differ, if at all, from those proposed:

SUBPART A -- GENERAL

SECTION 226.4 -- Finance Charge

4(b) Examples of Finance Charges

Paragraph 4(b)(5)

Comment 4(b)(5)-2 is added to explain the treatment of residual value insurance in a credit transaction. This type of insurance has been associated with balloon payment financing, particularly automobile balloon payment financing. In such a transaction, the creditor may agree to purchase, at the end of the

loan term, the property sold to the consumer for a price equal to the final balloon payment owed by the consumer, in lieu of that payment. Residual value insurance guarantees the estimated end of term value of the property. Comment 4(b)(5)-2 has been revised to make clear that premiums for residual value insurance are included in the finance charge for the period that the insurance is to be maintained, but only to the extent that a consumer is separately charged for the coverage. The premiums for the insurance are not considered part of the finance charge if the creditor pays the premiums and absorbs the cost (even if the creditor includes the cost in the cash price of goods or services or includes the cost in determining an interest rate to be charged).

SUBPART B -- OPEN-END CREDIT

SECTION 226.7 -- Periodic Statement

7(c) Credits

Comment 7(c)-4 is added -- with minor changes from that proposed -- to make clear that, where the creditor lists credits made to the account during the billing cycle, the regulation does not require that the creditor also disclose a total for each particular type of credit made to the account (for example, payments); nor does the regulation require that the creditor provide a total figure for all credits made to the account during the billing cycle.

SECTION 226.8 -- Identification of Transactions

Certain material has been deleted in comment 8-5; the deleted material is incorporated in new comment 8-8. Comment 8-8 is added to clarify the identification of transaction requirements for transactions in which a creditor and a seller have a corporate connection. Comment 8-8 makes clear that in

certain instances creditors may describe transactions involving sellers with whom they have a corporate connection using the identification requirements for unrelated creditors and sellers (§ 226.8(a)(3)), instead of the identification requirements for related creditors and sellers (§ 226.8(a)(2)). Creditors may use the rules in § 226.8(a)(3) when (1) the transactions occur under a credit plan that was established primarily for use with sellers that do not have a corporate connection with the creditor, or (2) the transactions involve a seller whose connection with the creditor would not be known to the consumer (for example, where the creditor's and seller's names are not similar, and the periodic statements are issued only in the creditor's name). The second situation, which was previously addressed by comment 8-5, is now addressed in new comment 8-8. Staff believes that, in the circumstances described in comment 8-8, the information provided to consumers under § 226.8(a)(3) would be at least as useful as that provided under § 226.8(a)(2).

Editorial changes have been made to the proposed language of comments 8-5 and 8-8.

SECTION 226.12 -- Special Credit Card Provisions

12(d) Offsets by Card Issuer Prohibited

Action is not being taken at this time on the proposed changes to comment 12(d)(2)-1 and the proposed deletion of comment 12(d)(2)-2. The proposed changes addressed the security interest exception in § 226.12(d) of Regulation Z, which implements § 169 of the Truth in Lending Act.

Section 169 of the act prohibits a card issuer from taking any action to offset a cardholder's indebtedness under a credit card plan against funds of the cardholder held on deposit with the card issuer. Since the statute provides

only one exception to this prohibition -- an exception for plans in which a cardholder authorizes the card issuer to periodically deduct all or part of the cardholder's credit card debt from deposit accounts held with the card issuer -- questions arose in the past as to whether a cardholder's deposit accounts could ever serve as security for credit card indebtedness.

Recognizing that there were instances where security interests were called for -- for example, an applicant for an open-end credit card account may be required to provide collateral to obtain or retain a credit card account -- the Board provided in Regulation Z that consensual security interests in deposit accounts could be taken without violating the offset prohibition. There is some evidence, however, that this position has been interpreted as allowing card issuers to debit cardholders' accounts pursuant to language routinely included in all cardholder contracts that takes a security interest in deposit accounts.

The proposed changes were intended to provide additional guidance on the security interest exception to the offsets prohibition. Some of the commenters on the proposal, however, expressed concern about the impact of the proposed changes and questioned whether the changes as proposed correctly addressed the issue. As a result, action is not being taken at this time in order to more fully explore the concerns raised and the issues involved.

SECTION 226.16 -- Advertising

16(b) Advertisement of Terms That Require Additional Disclosures

A new comment 16(b)-1 is added to indicate that, in an advertisement, the disclosures required by § 226.16(b)(1)-(3) need be made only when the advertisement reflects one or more of the disclosure terms contained in § 226.6(a)

or 226.6(b). In light of this new comment, comment 16(b)-2 is redesignated comment 16(b)-3 and is revised to delete the example indicating that the implicit disclosure of a security interest requires that the additional advertising disclosures of § 226.16(b)(1)-(3) be made. Present comment 16(b)-1 is redesignated comment 16(b)-2, and comments 16(b)-3 through 16(b)-7 are redesignated comments 16(b)-4 through 16(b)-8.

SUBPART C -- CLOSED-END CREDIT

SECTION 226.17 -- General Disclosure Requirements

17(a) Form of Disclosures

Paragraph 17(a)(1)

Comment 17(a)(1)-4 is revised to clarify the existing rule on disclosing certain security interest charges under sections 226.4(e) and 226.18(o). Footnote 38 gives creditors the option of making this disclosure either with the segregated disclosures or elsewhere. The revised comment makes clear that if a creditor chooses to list security interest charges in the itemization of the amount financed, no further disclosure of those charges is necessary.

A provision is added to comment 17(a)(1)-5 allowing specific information about certain prepayment penalties to be included with the segregated disclosures. In cases where federal or state law prohibits the assessment of a prepayment penalty, creditors that are permitted to charge interest for some period after prepayment in full may make a statement to that effect without identifying the charge as a penalty.

Comment 17(a)(1)-7 is added to clarify the disclosure requirements with regard to balloon payment financing, having some characteristics of both a lease transaction subject to Regulation M and a credit transaction subject to

Regulation Z. The final comment differs somewhat from the proposed comment which used a title concept to distinguish between a lease transaction and a credit transaction. The distinction between such transactions is generally based on ownership rights. Although legal or equitable title is considered an element of ownership, it is not always determinative of whether a transaction is a credit transaction or a lease transaction. Such a determination is more appropriately based on which party to a transaction has the indicia of ownership, including the risks, benefits and burdens of ownership.

Paragraph 17(c)(2)

Comment 17(c)(2)-3 is added to clarify the use of estimated disclosures in simple-interest transactions. Creditors may label disclosures as estimates because of possible inaccuracies resulting from consumers' payment patterns. Creditors also have the option of not labelling disclosures as estimates and assuming that all payments will be made on the scheduled dates in making their disclosure calculations.

SECTION 226.18 -- Content of Disclosures

18(f) Variable Rate

A cross-reference is added to comment 18(f)-2 to point out the redisclosure rules in comment 19(b)-4, which apply to some variable-rate transactions subject to early disclosure requirements.

Proposed comment 18(f)-6, which covered mortgages containing an option for consumers to convert an adjustable-rate mortgage to a fixed-rate mortgage, has been deleted in view of expected revisions to disclosure regulations for adjustable-rate mortgages by several federal agencies.

18(k) Prepayment

Paragraph 18(k)(1)

Comment 18(k)(1)-1 is revised to clarify that prepayment penalties include interest charges assessed for any period of time after the date prepayment in full is made. Such charges are assessed strictly because prepayment in full has been made at a date earlier than maturity. For example, under regulations of the Department of Housing and Urban Development (24 CFR Parts 203, 213, 222 and 234), a lender who accepts prepayment in full on a date other than the installment due date may assess a charge for interest to the end of the month. The revision makes clear that any interest charge assessed from the date of prepayment in full until the end of the month is a prepayment penalty. A cross-reference to comment 17(a)(1)-5 is added to identify permissible additional information that may be included with this disclosure.

18(m) Security Interest

Comments 18(m)-1 and 18(m)-3 are amended to clarify acceptable descriptions of security interests for transactions in which the proceeds, or a portion of the proceeds, are used to purchase the collateral. The revisions make clear that creditors may identify the collateral generally with a phrase such as "the property purchased" or, instead, may identify the collateral by item or type.

SECTION 226.19 -- Certain Residential Mortgage Transactions

19(b) Redisclosure Required

A paragraph is added to address the basis of disclosures when creditors redisclose at settlement and settlement occurs later than consummation. In these transactions, whether fixed-rate or variable-rate, creditors may base the disclosures on the terms in effect at settlement, rather than at consummation.

SECTION 226.23 -- Right of Rescission

23(f) Exempt Transactions

Comment 23(f)-8 is revised to clarify the application of the right of rescission to an account that converts from an open-end to a closed-end transaction. In some cases, as permitted by comment 17(b)-2, creditors delay closed-end disclosures until conversion of an account even if consummation of the closed-end transaction occurs when the account is opened. Comment 23(f)-8 is amended to provide that no new right of rescission arises at conversion, regardless of a creditor's compliance with rescission provisions at the opening of an account. Rescission rights set out in section 226.15 are unaffected.

SECTION 226.24 -- Advertising

Comments 24(b)-1 and 24(c)(2)-3 are amended to permit the abbreviation "APR" to be used instead of the term "annual percentage rate" in advertisements. This change makes the advertising of annual percentage rates for open-end and closed-end credit more consistent.

List of Subjects in 12 CFR Part 226

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

(3) Text of revisions. The revisions to the commentary (TIL-1, Supplement I to 12 CFR Part 226) read as follows:

SUPPLEMENT I - Official Staff Commentary - TIL-1

SUBPART A -- GENERAL

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SECTION 226.4 -- Finance Charge

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4(b) Examples of Finance Charges

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Paragraph 4(b)(5)

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▸ 2. Residual value insurance. Where a creditor requires a consumer to maintain residual value insurance or where the creditor is a beneficiary of a residual value insurance policy written in connection with an extension of credit (as is the case in some forms of automobile balloon payment financing, for example), the premiums for the insurance must be included in the finance charge for the period that the insurance is to be maintained. If a creditor pays for residual value insurance and absorbs the payment as a cost of doing business, such costs are not considered finance charges. (See comment 4(a)-2.)◂

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SUBPART B -- OPEN-END CREDIT

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SECTION 226.7 -- Periodic Statement

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7(c) Credits

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▸ 4. Totals. Where the creditor lists the credits made to the account during the billing cycle, the creditor need not disclose total figures for the amounts credited.◂

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SECTION 226.8 -- Identification of Transactions

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5. Same or related persons. ▸For purposes of identifying transactions, the◂ [The] term "same or related persons" refers to, for example:

- Franchised or licensed sellers of a creditor's product or service
- Sellers who assign or sell open-end sales accounts to a creditor or arrange for such credit under a plan that allows the consumer to use the credit only in transactions with that seller

[A person is not related to the creditor merely because, for example:

- The person and the creditor have an agreement by which the person is authorized to honor the creditor's credit card under the terms specified in the agreement
- The person and the creditor have a corporate connection, such as subsidiary-parent, if that connection is not obvious from the names they use. For example, if XYZ card issuer owns the ABC hotel, the card issuer and the hotel are not "related."]

▸ A seller is not related to the creditor merely because the seller and the creditor have an agreement authorizing the seller to honor the creditor's credit card.◂

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▸ 8. Transactions involving creditors and sellers with corporate connections. In a credit card plan established for use primarily with sellers that have no corporate connection with the creditor, the creditor may describe all transactions under the plan by using the rules in section 226.8(a)(3) -- creditor and seller not same or related persons -- including transactions involving a seller that has a corporate connection with the creditor. In other credit card plans, the creditor may describe transactions involving a seller that has a corporate connection with the creditor, such as subsidiary-parent, using the rules in section 226.8(a)(3) where it is unlikely that the consumer would know of the corporate connection between the creditor and the seller -- for example,

where the names of the creditor and the seller are not similar, and the periodic statement is issued in the name of the creditor only.◀

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SECTION 226.16 -- Advertising

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16(b) Advertisement of Terms That Require Additional Disclosures

▶ 1. Terms requiring additional disclosures. In section 226.16(b) the phrase "the terms required to be disclosed under section 226.6" refers to the terms in section 226.6(a) and 226.6(b).◀

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Comment 16(b)-1 is redesignated comment 16(b)-2.

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[2.] ▶3.◀ Implicit terms. Section 226.16(b) applies even if the triggering term is not stated explicitly, but may be readily determined from the advertisement. [For example, a statement that "the equity in your home becomes spendable with an XYZ line of credit" implicitly states that the creditor will take a security interest in the consumer's home.]

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Comments 16(b)-3 through 16(b)-7 are redesignated comments 16(b)-4 through 16(b)-8.

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SUBPART C -- CLOSED-END CREDIT

SECTION 226.17 -- General Disclosure Requirements

17(a) Form of Disclosures

Paragraph 17(a)(1)

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4. Content of segregated disclosures. Footnotes 37 and 38 contain exceptions to the requirement that the disclosures under section 226.18 be segregated from material that is not directly related to those disclosures. Footnote 37 lists the items that may be added to the segregated disclosures, even though not directly related to those disclosures. Footnote 38 lists the items required under section 226.18 that may be deleted from the segregated disclosures and appear elsewhere. Any one or more of these additions or deletions may be combined and appear either together with or separate from the segregated disclosures. The itemization of the amount financed under section 226.18(c), however, must be separate from the other segregated disclosures under section 226.18. ▶If a creditor chooses to include the security interest charges required to be itemized under sections 226.4(e) and 226.18(o) in the amount financed itemization, it need not list these charges elsewhere.◀

5. Directly related. The segregated disclosures may, at the creditor's option, include any information that is directly related to those disclosures. Directly related information includes, for example, the following: ***

▶ ∘ If a state or federal law prohibits prepayment penalties and excludes the charging of interest after prepayment from coverage as a penalty, a statement that the borrower may have to pay interest for some period after prepayment in full. The disclosure given under section 226.18(k) may state, for example, "If you prepay your loan on other than the regular installment date, you may be assessed interest charges until the end of the month."◀

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▶ 7. Balloon payment financing with leasing characteristics. In certain credit sale or loan transactions, a consumer may reduce the dollar amount of the payments to be made during the course of the transaction by agreeing to make, at the end of the loan term, a large final payment based on the expected residual

value of the property. The consumer may have a number of options with respect to the final payment, including, among other things, retaining the property and making the final payment, refinancing the final payment, or transferring the property to the creditor in lieu of the final payment. Such transactions may have some of the characteristics of lease transactions subject to Regulation M, but are considered credit transactions where the consumer assumes the indicia of ownership, including the risks, burdens and benefits of ownership upon consummation. These transactions are governed by the disclosure requirements of this regulation instead of Regulation M. Creditors should not include in the segregated Truth in Lending disclosures additional information. Thus, disclosures should show the large final payment in the payment schedule and should not, for example, reflect the other options available to the consumer at maturity.◀

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Paragraph 17(c)(2)

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▶ 3. Simple-interest transactions. If consumers do not make timely payments in a simple-interest transaction, some of the amounts calculated for Truth in Lending disclosures will differ from amounts that consumers will actually pay over the term of the transaction. Creditors may label disclosures as estimates in these transactions. For example, because the finance charge and total of payments may be larger than disclosed if consumers make late payments, creditors may label the finance charge and total of payments as estimates. On the other hand, creditors may choose not to label disclosures as estimates and may base all disclosures on the assumption that payments will be made on time, disregarding any possible inaccuracies resulting from consumers' payment patterns.◀

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SECTION 226.18 -- Content of Disclosures

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18(f) Variable Rate

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2. Basis for disclosures. For transactions subject to the requirements of section 226.18(f), the disclosures must be given for the full term of the transaction and must be based on the terms in effect at the time of consummation. However, in a variable-rate transaction with either a seller buydown that is reflected in the credit contract or a consumer buydown, disclosures should not be based solely on the initial terms. In those transactions, the disclosed annual percentage rate should be a composite rate based on the lower rate for the buydown period and the rate that is the basis of the variable rate feature for the remainder of the term. (See the commentary to section 226.17(c) for a discussion of buydown transactions[.)] ▸and the commentary to section 226.19(b) for a discussion of the redisclosure of certain residential mortgage transactions with a variable-rate feature.)◂

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18(k) Prepayment

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Paragraph 18(k)(1)

1. Penalty. This applies only to those transactions in which the interest calculation takes account of all scheduled reductions in principal, as well as transactions in which interest calculations are made daily. The term "penalty" as used here encompasses only those charges that are assessed strictly because of the prepayment in full of a simple-interest obligation, as an addition to all other amounts. [Items which are not penalties include, for example:

- Loan guarantee fees
- Interim interest on a student loan

However, a minimum finance charge is a penalty in a simple-interest transaction. (See the commentary to section 226.17(a)(1) regarding the disclosure of a minimum finance charge as directly related information.)] ▸Items which are penalties include, for example:

- Interest charges for any period after prepayment in full is made. (See the commentary to section 226.17(a)(1) regarding disclosure of interest charges assessed for periods after prepayment in full as directly related information.)
- A minimum finance charge in a simple-interest transaction. (See the commentary to section 226.17(a)(1) regarding the disclosure of a minimum finance charge as directly related information.)

Items which are not penalties include, for example:

- Loan guarantee fees
- Interim interest on a student loan◂

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18(m) Security Interest

1. Purchase money transactions. When the collateral is the item purchased as part of, or with the proceeds of, the credit transaction, section 226.18(m) requires only a general identification such as "the property purchased in this transaction." [The] ▸However, the◂ creditor may [give a more specific identification of the collateral, although only the abbreviated disclosure is necessary.] ▸identify the property by item or type instead of identifying it more generally with a phrase such as "the property purchased in this transaction." For example, a creditor may identify collateral as "a motor vehicle," or as "the property purchased in this transaction."◂ Any transaction in which the credit is being

used to purchase the collateral is considered a purchase money transaction and the abbreviated property identification may be used, whether the obligation is treated as a loan or a credit sale.

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3. Mixed collateral. In some transactions in which the credit is used to purchase the collateral, the creditor may also take other property of the consumer as security. In those cases, a combined disclosure must be provided, consisting of [the abbreviated property identification for the purchase money collateral] ▶an identification of the purchase money collateral consistent with comment 18(m)-1◀ [(although more detail may be given, at the creditor's option)] and a [more] specific identification of the other collateral ▶consistent with comment 18(m)-2◀.

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SECTION 226.19 -- Certain Residential Mortgage Transactions

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19(b) Redisclosure Required

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▶ 4. Basis of disclosures. In some cases, a creditor may delay redisclosure until settlement, which may be at a time later than consummation. If a creditor chooses to redisclose at settlement, disclosures may be based on the terms in effect at settlement, rather than at consummation. For example, in a variable-rate transaction, a creditor may choose to base disclosures on the terms in effect at settlement despite the general rule in the commentary to section 18(f) that variable-rate disclosures should be based on the terms in effect at consummation.◀

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SECTION 226.23 -- Right of Rescission

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23(f) Exempt Transactions

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8. Converting open-end to closed-end credit. Under certain state laws, consummation of a closed-end credit transaction may occur at the time a consumer enters into the initial open-end credit agreement. As provided in the commentary to section 226.17(b), closed-end credit disclosures may be delayed under these circumstances until the conversion of the open-end account to a closed-end transaction. In accounts secured by the consumer's principal dwelling, no new right of rescission arises at the time of conversion▶.◀ [,assuming that the right of rescission was previously provided on the open-end account pursuant to section 226.15.] ▶ Rescission rights under section 226.15 are unaffected.◀

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SECTION 226.24 -- Advertising

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24(b) Advertisement of Rate of Finance Charge

1. Annual percentage rate. Advertised rates must be stated in terms of an "annual percentage rate," as defined in section 226.22. Even though state or local law permits the use of add-on, discount, time-price differential, or other methods of stating rates, advertisements must state them as annual percentage rates. Unlike the transactional disclosure of an annual percentage rate under section 226.18(e), the advertised annual percentage rate need not include a descriptive explanation of the term [.] ▶and may be expressed using the abbreviation "APR."◀ The advertisement must state that the rate is

subject to increase after consummation if that is the case, but the advertisement need not describe the rate increase, its limits, or how it would affect the payment schedule. As under section 226.18(f), relating to disclosure of a variable rate, the rate increase disclosure requirement in this provision does not apply to any rate increase due to delinquency (including late payment), default, acceleration, assumption, or transfer of collateral.

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24(c) Advertisement of Terms That Require Additional Disclosure

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Paragraph 24(c)(2)

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3. Annual percentage rate. ▸The advertised annual percentage rate may be expressed using the abbreviation "APR."◂ The advertisement must also state, if applicable, that the annual percentage rate is subject to increase after consummation.

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Board of Governors of the Federal Reserve System, March 31, 1986.

(signed) William W. Wiles
William W. Wiles
Secretary of the Board