

FEDERAL RESERVE BANK OF DALLAS

DALLAS, TEXAS 75222

Circular No. 78-130
September 13, 1978

PROPOSED INTERPRETATION TO REGULATION Z--TRUTH-IN-LENDING

Reduction on Time Deposits Used to Secure Loans

TO ALL BANKS, OTHER CREDITORS,
AND OTHERS CONCERNED IN THE
ELEVENTH FEDERAL RESERVE DISTRICT:

The Board of Governors of the Federal Reserve System has proposed for comment through September 29 an interpretation of Regulation Z that requires disclosure of loss of interest when a time deposit is used as security for a loan. Under the interpretation, the amount of such a loss, when caused by State law, need not be disclosed.

When a time deposit is used as security for a loan, Federal law requires that the interest on the loan be at least 1 percentage point more than the interest the customer is receiving on the time deposit. That is, if the time deposit pays 7 1/2 percent interest, the interest on a loan for which the time deposit is collateral must be at least 8 1/2 percent.

However, some State laws fix maximum interest rates. In certain cases, the State maximum would be less than the creditor would be required to charge on a loan secured by a time deposit. For example, the State interest rate maximum might be 8 1/4 percent. That would be less than the 8 1/2 percent interest rate required to maintain the 1 percentage point differential in the example above. In such a case, the rate being paid on the time deposit must be reduced (from 7 1/2 to 7 1/4 percent). In this way, when the mandatory 1 percentage point differential for a loan secured by a time deposit is added, the interest charged the customer on the loan remains within the State maximum of 8 1/4 percent.

Such cases have resulted in questions whether the consequent loss of interest on the time deposit should be disclosed as a part of the finance charge.

The proposed interpretation would rule that it need not be made a part of the finance charge or be disclosed as such, but that the creditor must disclose that there will be a loss of interest.

Comments on the proposed interpretation should be directed to the Secretary, Board of Governors of the Federal Reserve System, Washington, D.C. 20551, and all correspondence should refer to Docket No. R-0177. A copy of the Board's order as it appeared in the *Federal Register* is printed on the following pages.

Sincerely yours,
Robert H. Boykin
First Vice President

Extract From
Federal Register
VOL. 43, NO. 170
Thursday, August 31, 1978
pp. 38849 - 38850

[6210-01]

FEDERAL RESERVE SYSTEM

[12 CFR Part 226]

[Reg. Z; Docket No. R-0177]

TRUTH IN LENDING

**Interest Reduction on Time Deposits Used to
Secure Loans**

AGENCY: Board of Governors of the
Federal Reserve System.

ACTION: Proposed interpretation.

SUMMARY: The proposed interpretation provides that an interest reduction on a time deposit used to secure a loan must be disclosed for Truth in Lending purposes. It would not, however, require disclosure of the amount of the interest reduction as a component of the finance charge or in other items on which the finance charge has a bearing—such as the annual percentage rate, schedule of payments, and total of payments. The interpretation would apply only in cases where a creditor must reduce the interest rate on the time deposit in order to comply with both a State loan rate ceiling and a percentage differential required by Federal or State law as to loans secured by time deposits. If a lending institution could maintain the percentage differential by increasing the interest charged on the loan, but chose instead to reduce the interest payable on the time deposit, the amount of the interest forfeited by the customer would have to be included in the finance charge and taken into account in other applicable Truth in Lending disclosures.

DATE: Comment must be received on or before September 29, 1978.

ADDRESS: Secretary, Board of Governors of the Federal Reserve System, Washington, D.C. 20551.

FOR FURTHER INFORMATION CONTACT:

Dolores S. Smith, Section Chief, Division of Consumer Affairs, Board of Governors of the Federal Reserve System, Washington, D.C. 20551, 202-452-2412.

SUPPLEMENTARY INFORMATION:

(1) Regulation Z requires that "all charges, payable directly or indirectly by the customer, and imposed directly or indirectly by the creditor as an incident to or as a condition of the extension of credit, whether paid or payable by the customer, seller, or any other person on behalf of the customer" be included in the finance charge.

An interpretation has been requested as to whether this requirement applies to interest that is forfeited on a time deposit used by the depositor to secure a loan. Under regulations of the Federal Reserve Board (regulation Q) and the other financial regulatory agencies, loans secured by time deposits are subject to a requirement that the lending institution maintain a 1 percent differential in the interest rates. That is, the lending institution must charge the customer an interest rate on the loan that is not less than 1 percent in excess of the interest rate being paid to the customer on the time deposit. The differential is intended to prevent evasion of regulations which impose a mandatory penalty on depositors for early withdrawal of a time

deposit, by discouraging loans that enable a depositor indirectly to obtain use of the funds before maturity.

In some States the maximum rate of interest allowed on certain types of loans is fixed by statute at a rate that is less than 1 percent in excess of the rate on the time deposit. This means that in order to maintain the differential, a lending institution must reduce the interest rate on the time deposit for the duration of the loan. For example, if the maximum rate is 8.50 percent for loans and the interest on the time deposit is 7.75 percent, the lender will pay the borrower a reduced rate of 7.50 percent on the time deposit. A lender that fails to maintain the differential will be in violation of Federal, and perhaps State, law.

The proposed interpretation would apply only in those cases where the combination of a loan rate ceiling and a differential requirement makes an interest reduction necessary. Where the interest rate ceiling on a loan is fixed by State law at a level that is 1 percent or more in excess of the rate on the time deposit, a lending institution can comply with the differential requirement without reducing the interest on the time deposit. If a lender could permissibly charge an increased rate on the loan, but chose instead to reduce the rate on the time deposit, the lender would have to include the lost interest in the finance charge, as well as in all other applicable regulation Z disclosures.

(2) To aid in the consideration of this matter by the Board, interested persons are invited to submit relevant data, views, comments, or arguments. Any such material should be submitted in writing to the Secretary, Board of Governors of the Federal Reserve System, Washington, D.C. 20551, to be received no later than September 29, 1978, and should include the docket No. R-0177. The material submitted will be made available for inspection and copying upon request, except as provided in § 261.6(a) of the Board's rules regarding availability of information (12 CFR 261.6(a)).

(3) Pursuant to the authority granted in 15 U.S.C. § 1064 (1968), the Board proposes to revise regulation Z, 12 CFR Part 226, by adding the following interpretation.

§ 226.408 Interest reduction on time deposits used to secure loans.

Section 226.4(a) requires that the amount of the finance charge in a credit transaction be determined as the sum of "all charges, payable directly or indirectly by the customer, and imposed directly or indirectly by the creditor as an incident to or as a condition of the extension of credit."

The question is whether this requirement applies to interest forfeited by a depositor on a time deposit because of a percentage differential mandated by Federal or State

laws, or both, for the loans secured by such deposits. In some States, the interest rate ceiling on loans secured by time deposits is such that the lender can comply with the differential requirement only by reducing the interest rate on the time deposit for the duration of the loan. For example, where the ceiling for loans is fixed at 8.50 percent and the interest rate on the time deposit is 7.75 percent, a reduction on the time deposit to 7.50 percent will be necessary to comply with the present 1 percent differential requirement.

It can be argued that in these cases any interest reduction results from a combination of the fixed loan interest rate and the mandatory percentage differential and, thus, is not a condition of the transaction imposed by the creditor. The Board concludes, however, that the interest forfeiture is so directly related to the loan transaction that it must be deemed to constitute a finance charge. To ignore the forfeiture altogether would result in an incomplete and misleading disclosure for purposes of Truth in Lending.

Although the Board concludes that the lost interest is a finance charge, a requirement that creditors disclose the amount as part of the finance charge, in a form that would be meaningful to the consumer, raises certain practical problems. These problems occur, in part, because of the fact that the consumer will not be paying out the lost interest, but rather will be foregoing its receipt. To require disclosure of the lost interest as a part of the finance charge would therefore require disclosing this and other amounts (such as the amount of scheduled payments and the total of payments) in hypothetical terms.

The Board believes the purposes of Truth in Lending will better be satisfied by a disclosure of the interest forfeiture as a credit term on the Truth in Lending disclosure statement. A creditor may satisfy this requirement, for example, by disclosing that "The interest rate on the time deposit offered as security for this loan will be reduced from 7.75 percent to 7.50 percent for the duration of this loan."

This exception, which permits a lender to omit the amount of the interest forfeiture in computing the finance charge and in other disclosures that relate in some way to the finance charge, is available only if the interest reduction results from the need to comply with a loan rate ceiling in combination with a differential requirement. If a lending institution could maintain the percentage differential by increasing the interest rate charged on the loan, but chose instead to reduce the interest rate payable to the depositor, any lost interest would represent a condition of the transaction imposed by the creditor. In these latter instances the amount of the interest forfeited by the consumer must be included in the finance charge and taken into account in other applicable disclosures.

By order of the Board of Governors,
August 23, 1978.

THEODORE A. ALLISON,
Secretary of the Board.

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