



FEDERAL RESERVE BANK  
OF DALLAS

WILLIAM H. WALLACE  
FIRST VICE PRESIDENT

December 30, 1986

DALLAS, TEXAS 75222

Circular 86-118

**TO:** The Chief Executive Officer of all  
member banks and others concerned in  
the Eleventh Federal Reserve District

**SUBJECT**

**Issuance of final rule, withdrawal of a proposed rule, and request  
for comment on amendment to official staff commentary, all pertaining to  
Regulation Z--Truth in Lending**

**DETAILS**

The Board of Governors of the Federal Reserve System has issued a final rule that would modify the Regulation Z provision granting exemptions to the right to rescission. As a result of the change, the funding of nonfinance charges would not be considered to constitute the advance of "new money" in the cases of certain refinancings.

The Board of Governors had previously proposed that the exemption from the Regulation Z rescission rule applicable to certain refinancings by the same creditor be extended to apply to certain "refinancings" by a different creditor. This proposal has been withdrawn.

The Board of Governors also has published for comment a proposed revision to the official staff commentary regarding the rescission rule.

Comments on the proposed amendment should be addressed to Mr. William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, Washington, D.C. 20551. All correspondence should refer to Docket No. R-0577, and must be received on or before January 30, 1987.

**ATTACHMENTS**

The material as published in the Federal Register is attached.

**MORE INFORMATION**

For further information, please contact David Dixon of this Bank's Legal Department at (214) 651-6228.

Sincerely yours,

A handwritten signature in cursive script that reads "William H. Wallace".

For additional copies of any circular please contact the Public Affairs Department at (214) 651-6289. Banks and others are encouraged to use the following incoming WATS numbers in contacting this Bank (800) 442-7140 (intrastate) and (800) 527-9200 (interstate).

FEDERAL RESERVE SYSTEM

12 CFR Part 226

[Regulation Z; Docket No. R-0577]

TRUTH IN LENDING

Right of Rescission

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final rule and withdrawal of proposed rule.

SUMMARY: The Board is publishing a final rule revising Regulation Z, its regulation implementing the Truth in Lending Act. The rule modifies the existing provision that exempts original creditors from providing the right of rescission in certain refinancings secured by the consumer's principal dwelling. The regulation provides that the right of rescission will not apply if the original creditor finances nonfinance charges such as attorney's fees, title examination fees, and insurance premiums.

The Board has decided to withdraw its proposal to amend Regulation Z to exclude certain transactions by a creditor other than the original creditor from the right of rescission. The proposal would have excluded from the right of rescission extensions of credit that replace a transaction secured by the consumer's principal dwelling where (1) no new advances of money are made to the consumer, (2) the annual percentage rate on the new obligation is not subject to increase after consummation and is the same as or lower than the annual percentage rate on the obligation being replaced, and (3) the new transaction does not have a balloon payment feature.

In light of significant concerns expressed by a number of persons commenting on the proposal, including significant consumer opposition to any expansion of the rescission exemptions, dissatisfaction with the limited nature

of the proposed exemption, the complexity associated with a rule that might accommodate all interests, and the statutory concerns accompanying any attempt to accommodate those interests, the Board has decided not to create a new rescission exemption for nonoriginal creditors.

EFFECTIVE DATE: December 16, 1986, but reliance optional until October 1, 1987.

FOR FURTHER INFORMATION: Contact Adrienne Hurt or Leonard Chanin, Staff Attorneys, (202) 452-3867 or (202) 452-3667, Division of Consumer and Community Affairs, or for the hearing impaired only, Telecommunications Device for the Deaf (TDD) Earnestine Hill or Dorothea Thompson, at (202) 452-3544, Board of Governors of the Federal Reserve System, Washington, D.C. 20551

SUPPLEMENTARY INFORMATION: (1) Background. Section 125 of the Truth in Lending Act (TILA) provides that consumers have the right to rescind certain credit transactions in which a security interest is taken in the consumer's principal dwelling. The right of rescission was established to provide consumers an opportunity to reexamine their credit contracts and cost disclosures in order to reconsider their decision to place an important asset -- the home -- at risk by offering it as security for the credit extension. The rescission period runs for three business days ending on midnight of the third business day following consummation, delivery of material Truth in Lending disclosures, or delivery to the consumer of the notice of the right to rescind, whichever occurs last. Under section 226.23 of Regulation Z, which implements the act's rescission provision, a creditor is prohibited from performing services or disbursing funds, other than in escrow, during the rescission period. A consumer may waive the right to rescind where the consumer has a bona fide personal financial emergency.

Currently, both the act and Regulation Z provide that refinancings<sup>1/</sup> by the same creditor of credit already secured by the consumer's principal dwelling are exempt from the right of rescission where no "new money" is advanced to the consumer. The regulation treats as new money the difference between the new "amount financed" and the unpaid principal balance plus any earned unpaid finance charges on the obligation being refinanced. Under this rule, nonfinance charges, such as attorney's fees, title examination fees and insurance premiums, if financed by the creditor, are added to the old debt to arrive at the new amount financed. The provisions in existing section 226.23 (f)(2) provide that the transaction is rescindable to the extent of these charges.

In light of the substantial increase in consumer applications to refinance residential mortgage loans, the Board received a number of inquiries and complaints about the applicability of the rescission rules to refinancings. As a result of consumer and creditor concerns, the Board published for public comment on August 6, 1986 (51 FR 28245) a proposal to create a new exemption from the right of rescission for transactions involving the nonoriginal creditor, and to revise the definition of new money for purposes of the current exemption for original creditors. The Board received approximately 165 comments on the proposed amendments. The Board has decided not to create

---

<sup>1/</sup> Although the term "refinancing" in § 226.23 of Regulation Z refers only to new transactions by the same creditor that had made the original extension of credit, the term in this discussion is used in a generic sense to refer to a transaction by any creditor that satisfies and replaces an existing obligation.

a new exemption for nonoriginal creditors, but has decided to revise its definition of new money for purposes of the existing exemption from the rescission right for original creditors.

(2) Proposal to exempt "refinancings" by the nonoriginal creditor.

Section 125(e) of the TILA exempts from rescission only refinancings by the original creditor where no new advances of money are made. The proposed amendment to Regulation Z would have expanded the class of transactions exempt from the rescission provisions to include certain types of refinancings by creditors other than the original creditor. The expansion of the rescission exemption to exempt certain additional types of refinancings was based on the idea that it would benefit both consumers (in allowing for immediate access to credit) and creditors (in relieving some compliance costs) and, if limited, would be consistent with congressional intent in creating the right of rescission. In an effort to ensure that transactions remain subject to the right of rescission where the consumer arguably needs the right, and in view of the existing statutory exemption applicable to the original creditor only, the proposal would have limited the types of refinancings offered by a new creditor that could be exempt from the right of rescission. Under the proposal, a refinancing by a new creditor would have qualified for the exemption only if:

- (1) no new advances of money were obtained by the consumer,
- (2) the annual percentage rate (APR) on the new transaction was not subject to increase after consummation and was the same as or lower than the APR on the obligation being refinanced, and
- (3) the new transaction did not have a balloon payment feature.

After careful consideration of the comment letters and further evaluation of the proposal, the Board has decided not to amend Regulation Z

to create a new exemption from the right of rescission for refinancings by a new creditor. The Board's decision is based on several considerations. First, there was a strong belief among persons opposed to expanding the rescission exemptions -- particularly those representing the consumer interest -- that the Board's proposed amendment would eliminate an important consumer right. These commenters felt that the purpose of the right of rescission -- to allow consumers time to reconsider the risks in encumbering their homes for an extension of credit -- is crucial, particularly at a time when so many consumers are refinancing loans. The opponents believed that the proposal, even with its limitations aimed at exempting only loans that would pose no greater risk than the original loans, was not sufficient to ensure that consumers will have the right of rescission in all transactions when it would be desirable. In addition to the concerns about the loss of a substantive consumer protection, those opposing the proposed amendment often cited their belief that the Board would be exceeding its rulemaking authority under the TILA if it were to exempt transactions by a creditor other than the original creditor because the current statute expressly exempts only refinancings by the same creditor.

While most commenters generally favored expansion of the category of refinancings that would be exempt from the rescission provisions, many commenters did not favor the Board's specific proposal. A number of creditors, for example, urged the Board to adopt similar exemption rules for original and nonoriginal creditors by deleting the various qualifications from the proposed amendment. They argued that where a consumer refinances a loan, regardless of who the creditor is, the right to rescind is an unnecessary protection because there is adequate time between application and closing for reconsideration of a credit decision. They also claimed there is little support for the idea that a consumer

undertakes less risk when refinancing a loan with the same creditor, or that the consumer needs the additional rescission protections only when dealing with a different creditor.

While the Congress' rationale for restricting the exception to the original creditor may be unclear, the statute unambiguously exempts refinancings only with the original creditor. It is the Board's view that adopting a broad exemption that would treat new creditors the same as original creditors would be inconsistent with the statutory intent of the rescission provisions. Any exemption would have to be tailored to ensure that the rescission provisions apply to transactions where the right of rescission is arguably a needed protection.

With regard to the exemption as proposed, many commenters urged that various modifications be made in the proposal to exempt additional transactions that they believed would impose no increased risk to consumers. For instance several commenters suggested that:

- The refinancing of a variable rate loan with no caps to a variable rate loan with caps should be exempt from the right of rescission.
- The refinancing of a fixed rate loan to a variable rate loan with a rate cap that is equal to or less than the APR (or interest rate) on the existing loan should be exempt from the right of rescission.
- Only where a balloon payment feature is added or where a balloon payment on the refinancing is higher than the balloon payment on an existing loan should the transaction remain subject to the right of rescission.

The Board believes that modifying the proposal to expand the rescission exemption to include more transactions in which additional risk is not an apparent concern would likely result in a very technical and complex rule.

Several commenters, in response to the Board's solicitation for comment as to whether additional limitations should be contained in the proposal,

felt that additional conditions should be imposed before a transaction is exempt from the right of rescission. Most of those addressing the question stated that refinancings with a demand feature should be subject to the right of rescission on the ground that a demand loan is just as risky, if not more so, than a loan with a balloon payment feature. Others stated that scheduled payments on the refinancing should be lower than scheduled payments on the existing loan before the right of rescission is eliminated. Other commenters suggested additional conditions. The Board believes that drafting a rule accommodating these concerns would create a very technical regulation, and would significantly limit the number of transactions that would be covered by the amendment.

In light of the strong opposition to any expansion of the rescission exemptions from a number of commenters, the desire of many commenters to have the rescission exemption expanded beyond that which was proposed by the Board, the complexity associated with a rule to accommodate all interests, and the statutory constraints, the Board has decided not to adopt the proposed amendment to create a new rescission exemption regarding refinancings by a creditor other than the original creditor.

(3) New money proposal. In addition to proposing to amend Regulation Z to exempt certain refinancings by a nonoriginal creditor, the Board proposed to redefine what constitutes a new advance of money obtained by a consumer for purposes of the existing exemption for refinancings. The Board has decided to adopt the proposed amendment to Regulation Z that would redefine a new advance of money. Section 226.23(f)(2) currently provides that a consumer shall receive the right of rescission in a refinancing by the original creditor if the consumer receives "new money." Under this rule, new money has been treated as the difference between the new amount financed and the outstanding balance plus any



earned unpaid finance charges. Because of this definition, the right of rescission often would be triggered if the consumer merely finances costs that are not finance charges, such as attorney's fees, title examination fees, and insurance premiums, even where a consumer does not get additional money for other purposes. The Board proposed for comment a revision to this rule to provide that if the new money results solely from a decision by the consumer to finance nonfinance charges such as attorney's fees, title examination fees, and insurance premiums, these costs would not trigger the right of rescission. (Under the existing rule, points and other finance charges, even if financed by the creditor, would not trigger the right of rescission since they are not part of the "amount financed.")

Over two-thirds of the commenters supported the Board's proposal to revise the definition of new money. The majority of commenters stated that most consumers ask to finance these costs when refinancing their mortgage, thus triggering the right of rescission in a large number of refinancings. While commenters varied in the estimates of these costs, it appears that these costs are generally below \$1,000 or 3% or less of the principal loan amount. Most commenters stated that these costs were not significant enough to justify the consumer receiving the right of rescission solely for these charges.

Several commenters opposed to revising the definition of new money stated that costs such as attorney's fees, title examination fees, and insurance premiums can be significant, and that consumers need an opportunity to reconsider a transaction when these costs are financed by a creditor. A few commenters felt the Board should not take any action that may reduce consumer protections in the rescission area.

After careful consideration of all comments received and further examination of the proposal, the Board has decided to adopt the new money

proposal. The Board believes that consumers do not need the right of rescission when refinancing with an original creditor if the only reason for receiving the right is due to a decision to finance nonfinance charge closing costs. Such amounts do not appear to be significant, in light of the principal loan amount being refinanced, and thus do not put the consumer's principal dwelling at any significantly greater risk.

The Board also believes that the requirement in section 226.4(c)(7) that common closing costs must be bona fide and reasonable to be excluded from the finance charge should allay concerns expressed by some commenters that creditors may use this revision to add unreasonable charges to the new transaction. Furthermore, it should be noted that if the consumer rescinds a transaction involving new money, section 226.23(d) provides that the consumer is not liable to pay any amount, including the cost of the refinancing.

Minor editorial revisions have been made to the proposal so that the provision will be phrased in terms of what transactions are subject to the right of rescission rather than what transactions are covered by the exemption. These revisions were made to more clearly state the rule that, where a transaction involves new money, only the new money is rescindable.

In addition to its final rule, the Board is also publishing for public comment in this issue of the Federal Register a proposal to amend the official staff commentary to address issues that may arise as a result of the new rule.

(4) Regulatory impact. The revision to the rescission provision in Regulation Z would reduce the number of transactions for which creditors would need to provide consumers with a notice of their rescission rights and an opportunity to rescind. Therefore, it appears that creditors, including small entities, would not incur any additional costs as a result of the proposed changes.

List of Subjects in 12 CFR 226

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

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

(1) The authority citation for Part 226 continues to read: AUTHORITY: Sec. 105, Truth in Lending Act, as amended by Sec. 605, Pub. L. 96-221, 945 Stat. 170 (15 U.S.C. § 1604 et seq.).

(2) 12 CFR Part 226 is amended by revising § 226.23(f)(2) to read as follows:

SECTION 226.23 -- Right of Rescission

\* \* \* \* \*

(f) Exempt transactions. The right to rescind does not apply to the following:  
\* \* \*

(2) A refinancing or consolidation by the same creditor of an extension of credit already secured by the consumer's principal dwelling. The right of rescission shall apply, however, to the extent the new amount financed exceeds the unpaid principal balance, any earned unpaid finance charge on the existing debt, and amounts attributed solely to the costs of the refinancing or consolidation.

\* \* \* \* \*

By order of the Board of Governors of the Federal Reserve System, December 11, 1986.

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

FEDERAL RESERVE SYSTEM

12 CFR Part 226

[Reg. Z; R-0577]

TRUTH IN LENDING

Proposed Update to Official Staff Commentary

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Proposed official staff interpretation.

SUMMARY: The Board is publishing for comment a proposed revision to the official staff commentary to Regulation Z (Truth in Lending) regarding the right of rescission in the refinancing of a closed-end credit transaction. The revision relates to an amendment to Regulation Z recently adopted by the Board that redefines what constitutes a new advance of money in a refinancing that is exempt from the rescission provisions. (The regulatory amendment is contained elsewhere in this issue.) The proposed commentary provision would revise existing comment 23(f)-4 which explains what constitutes a new advance of money in a refinancing by the original creditor that would require the creditor to give a consumer the opportunity to rescind an extension of additional credit.

DATE: Comments must be received on or before January 30, 1987.

ADDRESS: Comments should be mailed to William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, Washington, D.C. 20551, or delivered to the 20th Street mail services courtyard entrance, 20th Street between C Street and Constitution Avenue, N.W., Washington, D.C., between 8:45 a.m. and 5:15 p.m. weekdays. Comments should include a reference to R-0577. Comments may be inspected in Room B-1122 between 8:45 a.m. and 5:15 p.m. weekdays.

FOR FURTHER INFORMATION: Contact Adrienne Hurt or Leonard Chanin, Staff Attorneys, Division of Consumer and Community Affairs, at (202) 452-3867 or (202) 452-3667; for the hearing impaired only, Telecommunications Device for the Deaf (TDD) Earnestine Hill or Dorothea Thompson, at (202) 452-3544, Board of Governors of the Federal Reserve System, Washington, D.C. 20551.

SUPPLEMENTARY INFORMATION: (1) General. The Truth in Lending Act (TILA) provides that, in a consumer credit transaction in which the consumer's principal dwelling secures an extension of credit, the consumer has three business days, generally from the date of consummation of the credit transaction, in which to rescind the transaction. This right of rescission was created to allow consumers time to reexamine their credit contracts and cost disclosures and to reconsider whether they want to place an important asset -- the home -- at risk by offering it as security for the credit.

Not all credit transactions secured by a consumer's principal dwelling are subject to the right of rescission. Under section 125(e) of the TILA a refinancing by the same creditor (the original creditor) is not subject to the right of rescission if no new advances of money are made to the consumer. The Board has recently adopted an amendment to Regulation Z to redefine what constitutes a new advance of money obtained by a consumer for purposes of the rescission exemption for refinancings. The regulatory amendment is contained elsewhere in this issue. The amendment redefines a new advance of money as only amounts above the costs attributable to the refinancing that are in the amount financed.

Comment 23(f)-4 would be revised to incorporate the revised definition of a new advance of money in a refinancing and to further explain

what amounts are included in determining what constitutes a new advance. In addition, a minor editorial change would be made in the first sentence of comment 23(f)-4 to clarify that a consolidation is a type of refinancing. No substantive change is intended.

It is expected that revisions to comment 23(f)-4 will be adopted in final form in March 1987 (along with the final version of the sixth general update to the commentary to Regulation Z, a proposal of which was published at 51 FR 43,372 on December 2, 1986). Compliance would be optional until the uniform effective date of October 1, 1987, for mandatory compliance. Certain conventions have been used to highlight the proposed revision. New language is shown inside bold-faced arrows, and underlined, while language that would be deleted is set off with brackets.

Pursuant to authority granted in section 105 of the Truth in Lending Act (15 U.S.C. 1604 as amended), the Board proposes to amend the official staff commentary to Regulation Z (12 CFR Part 226 Supp. I) as follows:

List of Subjects in 12 CFR Part 226

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

For the reasons set forth above, the Board proposes to amend 12 CFR Part 226 as follows:

(1) The authority citation for Part 226 continues to read as follows:  
AUTHORITY: Sec. 105, Truth in Lending Act, as amended by sec. 605, Pub. L. 96-221, 94 Stat. 170 (15 U.S.C. 1604 et seq.).

(2) Text of revisions. The proposed revisions to the Official Staff Commentary (12 CFR Part 226, Supp. I) read as follows:

SUPPLEMENT I - Official Staff Interpretations

\* \* \* \* \*

Section 226.23 -- Right of Rescission

\*   \*   \*   \*   \*

23(f) Exempt Transactions

\*   \*   \*   \*   \*

4. New advances. The exemption in section 226.23(f)(2) applies only to refinancings [or consolidations] >(including consolidations)< by the original creditor. [If the transaction involves the advance of new money, then only the amount of the new money is rescindable. For example, if the sum of the outstanding principal balance plus the earned finance charge is \$1,000 and the new amount financed is \$1,000, then the refinancing would be exempt. On the other hand, if the new amount financed exceeds \$1,000, then the amount in excess of that \$1,000 would be rescindable.] >If the refinancing involves a new advance of money, the amount of the new advance is rescindable. For purposes of the right of rescission, a new advance does not include amounts attributed to the costs of the refinancing. These amounts would include section 226.4(c)(7) charges (such as attorneys fees and title examination and insurance fees, if bona fide and reasonable in amount), as well as insurance premiums and other charges that are not finance charges. (Finance charges on the new transaction -- points, for example -- would not be considered in determining whether there is a new advance of money in a refinancing since finance charges are always excluded from the amount financed.) To illustrate, if the sum of the outstanding principal balance plus the earned unpaid finance charge is \$50,000 and the new amount financed is \$51,000, then the refinancing would be exempt if the extra \$1,000 is attributed solely to costs financed in connection with the refinancing that are not finance charges. Of course, if new advances of money are made (for example, to

pay for home improvements) and the consumer exercises the right of rescission,  
the consumer must be placed in the same position as he or she was prior  
to entering into the new credit transaction. Thus, if applicable, all  
amounts of money (which would include all the costs of the refinancing)  
already paid by the consumer to the creditor or to a third party as part  
of the refinancing would have to be refunded to the consumer. (See the  
commentary to 226.23(d)(2) for discussion of refunds to consumers.) A  
model rescission notice applicable to transactions involving new advances  
appears in appendix H.

Board of Governors of the Federal Reserve System, December 11, 1986.

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