FEDERAL RESERVE BANK
OF DALLAS

WILLIAM H. WALLACE
FIRST VICE PRESIDENT
AND CHIEF OPERATING OFFICER

DALLAS, TEXAS 75222

September 22, 1987

Circular 87-68

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

SUBJECT

Request for public comment on proposed amendment to Regulation Z - Truth in Lending

DETAILS

The Board of Governors of the Federal Reserve System has requested comment on a proposed amendment to Regulation Z to implement a provision of the Competitive Equality Banking Act of 1987 regarding adjustable rate mortgage caps which would require creditors to include a limit on the maximum interest rate that may be charged on certain adjustable rate transactions.

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-0613, and must be received on or before October 14, 1987.

ATTACHMENTS

The Board's press release and the material as published in the Federal Register are attached.

MORE INFORMATION

For further information, please contact Sharon Sweeney of this Bank's Legal Department at (214) 651-6228. If you wish to receive additional copies of this circular, please contact our Public Affairs Department at 651-6289.

Sincerely yours,

William H. Wallace

FEDERAL RESERVE press release

For immediate release September 11, 1987

The Federal Reserve Board today requested comment on a proposed amendment to Regulation Z (Truth in Lending) to implement a provision of the Competitive Equality Banking Act of 1987 regarding adjustable rate mortgage caps which would require creditors to include a limit on the maximum interest rate that may be charged on certain adjustable rate transactions.

The proposed amendment would apply to both open-end and closed-end consumer credit transactions. It would apply to all dwelling-secured extensions of credit that require variable rate disclosures under Regulation Z, as well as open-end dwelling-secured lines of credit in which the creditor reserves the contractual right to make rate changes from time to time on an account.

The amendment would apply only to closed-end transactions or open-end programs entered into on or after December 8, 1987, the effective date of the law. The rule would not apply retroactively to existing transactions or programs. Under the proposed amendment, creditors would be required to specify in their credit contracts the maximum interest rate that may be imposed during the term of the obligation.

Comments should be received by the Board on this matter by October 14, 1987.

The Board's notice is attached.

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Attachment

FEDERAL RESERVE SYSTEM

12 CFR Part 226

[Regulation Z; Docket No. R-0613]

Truth in Lending; Competitive Equality Banking Act

Maximum Interest Rate Limitations

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Proposed rule.

SUMMARY: The Board is proposing to revise Regulation Z (Truth in Lending) to implement Title XII, section 1204 of the Competitive Equality Banking Act of 1987. Section 1204 provides that, effective December 8, 1987, any adjustable rate mortgage loan originated by a creditor must include a limitation on the maximum interest rate that may apply during the term of the mortgage loan. The proposed amendment to Regulation Z incorporates the substance of the new law into the regulation. The proposed amendment would apply to both open-end and closed-end consumer credit transactions covered by the Truth in Lending Act and Regulation Z. The amendment would apply to all dwelling-secured extensions of credit that require variable rate disclosures under Regulation Z, as well as open-end dwelling-secured lines of credit in which the creditor reserves the contractual right to make changes in the terms and conditions of the account from time to time -- including rate changes. The amendment would apply only to closed-end credit transactions and open-end credit programs entered into on or after December 8, 1987. The rule would not apply retroactively to existing transactions or

programs. Under the proposed amendment, creditors would be required to specify in their credit contracts the maximum interest rate (a lifetime cap) that may be imposed.

DATE: Comments must be received on or before October 14, 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 Mail Services courtyard entrance on 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 Docket No. R-0613. Comments may be inspected in Room B-1122 between 8:45 a.m. and 5:15 p.m. weekdays.

FOR FURTHER INFORMATION CONTACT: Adrienne D. Hurt, Senior Attorney, Division of Consumer and Community Affairs, at (202) 452-2412 or 452-3867; for the hearing impaired only, contact Earnestine Hill or Dorothea Thompson, Telecommunications Device for the Deaf at (202) 452-3544, Board of Governors of the Federal Reserve System, Washington, D.C. 20551.

SUPPLEMENTARY INFORMATION: (1) Background. On August 10, 1987, the Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, 101 Stat. 552, was enacted into law. Title XII, section 1204 of the act provides that "[a]ny adjustable rate mortgage loan originated by a creditor shall include a limitation on the maximum interest rate that may apply during the term of the mortgage loan." (Section 1204 does not set the maximum interest rate.) An adjustable rate mortgage loan is defined in section 1204 as any loan secured by a lien on a one-to-four family

dwelling unit, where the loan is made pursuant to an agreement under which the creditor may, from time to time, adjust the rate of interest. Creditors who regularly extend credit for personal, family or household purposes are subject to the statutory requirement. Section 1204 further provides that failure to comply with the requirement is to be treated as a violation of the Truth in Lending Act. The section makes specific reference to civil liability and administrative enforcement under sections 130 and 108 of Truth in Lending, respectively. The law becomes effective on December 8, 1987.

Section 1204 was a floor amendment to the Senate's omnibus financial institutions bill, and was agreed to by House conferees working on the final bill. There is very little legislative history on section 1204 indicating the intent of Congress in enacting this provision, other than comments offered on the Senate floor. (See 133 Cong. Rec. S3945 (daily ed. March 20, 1987))

Given the broad language of section 1204, most of the questions asked about the new law concern the scope of its coverage. There have also been questions about the manner of compliance. Creditors have asked the following questions.

- Does the statute apply to business credit as well as consumer credit?
- Does the statute apply to both open-end and closed-end credit?
- Will the statute be applied retroactively to existing credit agreements, more specifically, assuming that

open-end credit is covered by section 1204, will the statute apply to new advances under an open-end credit plan that had been entered into prior to the effective date of the law?

- Again assuming coverage, can a creditor raise the maximum interest rate on an open-end plan by use of a change in terms notice? (See 226.9(c) of Regulation Z) Alternatively, can a creditor terminate an account when the maximum rate is reached?
- With regard to closed-end credit, if a consumer refinances or assumes an extension of credit, can the creditor increase the maximum rate?
- Does the statute require a creditor to include a limitation on incremental or periodic caps in a credit contract or only a limitation on a lifetime cap?
- Does the maximum interest rate have to be stated as a sum certain?

(2) The proposed amendment to Regulation Z. The proposed amendment to Regulation Z would incorporate the substance of section 1204 into a new section 226.30 to Subpart D of the regulation. In addition, technical amendments would be made to section 226.1 of Regulation Z, in the paragraphs on Board authority, organization of the regulation, and enforcement and liability (to incorporate by reference administrative enforcement and civil liability provisions of the Truth in Lending Act into section 1204(c)). The amendment would apply to dwelling-secured

extensions of credit covered by the Truth in Lending Act in which the creditor may make interest rate adjustments. Thus, it will apply only to consumer credit and not to business credit. The amendment covers both open-end and closed-end credit transactions. Thus, all dwelling-secured transactions that currently require variable rate disclosures under Truth in Lending will have a lifetime cap on the rate of interest that can be imposed. (See section 226.6(a)(2) footnote 12, and section 226.18(f) to Regulation Z; see also comment 226.6(a)(2)-2 and comments 18(f)-1 and 18(f)-6 in the Official Staff Commentary to Regulation Z regarding coverage of the variable rate disclosure requirements.)

In addition, there is one category of transactions that does not require variable rate disclosures under the Truth in Lending Act, but that falls squarely within the definition of transactions covered by section 1204: open-end home equity lines of credit in which the creditor reserves the contractual right to make rate adjustments on the account. (See comment 6(a)(2)-2 of the commentary) These transactions are not considered variable rate plans for purposes of Truth in Lending disclosure because the rate changes are discretionary and are not tied to an index or formula. (Although variable rate disclosures are not given, creditors are required under the Truth in Lending Act to provide written notice to a consumer of each rate increase in advance of the increase.) Under the proposal, creditors offering such programs will be required to set a lifetime cap on the interest rate.

The proposed amendment will cover applicable transactions entered into on or after December 8, 1987, the effective date of the law. The amendment would not apply retroactively to existing credit contracts. Consequently, new advances under preexisting open-end credit plans are not subject to section 1204.

Creditors would be required to specify in their credit contracts a maximum interest rate (a lifetime cap) that could be imposed. It is the creditor's determination as to what that rate will be. The rate must be stated as a sum certain or in a manner in which the consumer may easily ascertain the maximum rate. For example, the following statements would be sufficiently specific:

- The maximum interest rate will not exceed X%.
- The interest rate will never be higher than X percentage points above the initial rate of Y%.

Statements like the following, however, do not indicate a sum certain and would not comply with the regulation.

- The interest rate will never be higher than X percentage points over the going market rate.
- The interest rate will not exceed the state usury ceiling which is currently X%.

The latter example does not mean that a creditor may not establish a state usury ceiling as the maximum rate to be imposed on a credit transaction, since choice of a maximum rate is within the creditor's discretion. The problem with the latter statement is that it suggests that if the state usury ceiling later increases, then the maximum rate imposed on the credit

transaction will increase. That would not be consistent with the law since section 1204 requires that a maximum lifetime cap be set for the full term of the obligation. Similarly, if a creditor were to use a change in terms notice to increase a maximum interest rate that has been imposed on an open-end adjustable rate plan, the creditor would not, in fact, have set a maximum rate on the credit plan in accordance with section 1204. Therefore, creditors may not change the terms of existing plans to increase the maximum rate.

A creditor is not prohibited from terminating an open-end plan when the maximum interest rate set under the plan is reached. Nevertheless, the Board is concerned that such a practice could have an adverse effect on consumers. Of particular concern is the possibility that a creditor, in addition to suspending the consumer's ability to obtain additional funds under the line of credit, might reserve the right to require the consumer to pay the entire balance outstanding at the time the account is terminated because the maximum interest rate has been reached. Regulation Z does not currently call for disclosure of this right to terminate. The Board would like comment on whether an open-end creditor that has the right to terminate a plan, and requires payment of the outstanding balance in full when the maximum interest rate set under the plan is reached, should be required to specifically disclose this fact in the credit contract and/or the initial Truth in Lending disclosures.

The Board would also like to note here that it is currently studying the broader issue of whether the Truth in Lending disclosures for open-end home equity plans should be revised to take account of the special characteristics of these programs, which differ in many ways from the more traditional open-end credit programs. The terms and conditions of these programs are generally more complex and the consequences for consumers greater if they fail to understand the program. The Board will probably be considering this fall whether additional or different disclosure requirements should be applicable to open-end home equity lines of credit.

With respect to closed-end credit transactions subject to section 1204, the maximum interest set may not be increased during the term of the transaction. If there is a refinancing as defined in section 226.20(a), an assumption as defined in section 226.20(b), or any other situation constituting a new credit transaction subject to Regulation Z, however, a new interest rate cap may be set.

If any further guidance for compliance with section 1204 is necessary, the Board expects to incorporate it into the seventh proposed update to the Official Staff Commentary to Regulation Z that will be published for comment in November 1987.

(3) Interim compliance rule for certain closed-end creditors. Section 105(d) of Regulation Z requires the Board, except in limited circumstances, to delay the effective date of any change to Truth in Lending disclosure requirements to the October 1 following by six months the date a rule is promulgated. The

implementation of section 1204 will not change previous Truth in Lending disclosure requirements. Nevertheless, some creditors that currently offer uncapped closed-end adjustable rate loans may have to change their Truth in Lending disclosure forms to add a disclosure of the lifetime cap. (See section 226.18(f)(2) of Regulation Z.) Section 226.17(a) provides that all required Truth in Lending closed-end disclosures must be grouped together and presented separately from the contract. (Open-end credit disclosures are not subject to such requirement.) When the Board takes final action on the proposed Truth in Lending disclosure rules for adjustable rate mortgage transactions (the ARMs proposal) now pending, (51 FR 42241, Nov. 24, 1986) these creditors might again have tc alter their closed-end disclosure forms.

To avoid the burden of changing Truth in Lending disclosure forms twice in a short period of time, the proposal would allow closed-end creditors to have until October 1, 1988 to make the necessary revisions to their disclosure forms. For the interim period between December 8, 1987 and October 1, 1988, compliance with section 1204 -- that is, placing the maximum rate limitation in the credit contract -- would constitute compliance with the Regulation Z requirement to disclose interest rate caps in a closed-end variable rate credit transaction.

(4) Comments requested. Interested persons are invited to submit written comments on the proposed amendment and other matters addressed in this notice. After the close of the comment period,

based upon its analysis of the comments received, the Board will publish in the Federal Register notice of final action.

The comment period ends on October 14, 1987. Section 1204 becomes effective December 8, 1987. It is therefore imperative that comment be made in a timely manner. Because prompt resolution of these matters is essential and in the public interest, the expanded rulemaking procedure set forth in the Board's policy statement of January 15, 1979 (44 FR 3957) has not been followed.

(5) Economic Impact Statement. The Board's Division of Research and Statistics has prepared an economic impact statement on the proposed 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 226

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

(6) Text of proposed revision. Certain conventions have been used to highlight the proposed revisions. New language is shown inside arrows, while language that would be removed is set off with brackets. Pursuant to authority granted in Title XII, section 1204(b) of the Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, 101 Stat. 552, the Board proposes to amend Regulation Z (12 CFR Part 226) by revising paragraphs (a), (d) and (e) of section 226.1 and by adding a new section 226.30.

1. The authority citation for Part 226 is amended to read as follows:

Authority: Sec. 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 Banking Equality Act, Pub. L. No. 100-86, 101 Stat. 552<

2. The proposed revisions to Regulation Z (12 CFR Part 226) read as follows:

SUBPART A - GENERAL

SECTION 226.1 -- Authority, Purpose, Coverage, Organization, Enforcement and Liability

(a) Authority. This regulation, known as Regulation Z, is issued by the Board of Governors of the Federal Reserve System to implement the federal Truth in Lending and Fair Credit Billing Acts, which are contained in title I of the Consumer Credit Protection Act, as amended (15 USC 1601 et seq.) >This regulation also implements title XII, section 1204 of the Competitive Equality Banking Act of 1987 (Pub. L. No. 100-86, 101 Stat. 552).< * * *

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(d) Organization. The regulation is divided into subparts and appendices as follows:

* * * * *

(4) Subpart D contains rules on oral disclosures, Spanish language disclosure in Puerto Rico, record retention,

effect on state laws, [and] state exemptions[.] ▸, and rate limitations.◂

(e) Enforcement and liability. Section 108 of the act contains the administrative enforcement provisions. Section 112, 113, 130, 131, and 134 contain provisions relating to liability for failure to comply with the requirements of the act and the regulation. ▸Section 1204(c) of title XII of the Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, 101 Stat. 552, incorporates by reference administrative enforcement and civil liability provisions of sections 108 and 130 of the act.◂

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SUBPART D - MISCELLANEOUS

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>SECTION 226.30 -- Limitation on Rates

In a consumer credit transaction subject to the act and this regulation, a creditor shall include in the credit contract a limitation on the maximum interest rate that may be imposed during the term of the obligation[1] when --

(a) the annual percentage rate may increase after consummation or, in the case of open-end credit, when the annual percentage rate may change during the plan; and

(b) the transaction is secured by a dwelling.◂

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[1] When a creditor changes its credit contract(s) to comply with this section, that will constitute compliance with the disclosure requirements of section 226.18(f)(2) until October 1, 1988.◂

By order of the Board of Governors of the Federal Reserve System, September 11, 1987.

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