FEDERAL RESERVE BANK
OF DALLAS

WILLIAM H. WALLACE
FIRST VICE PRESIDENT
AND CHIEF OPERATING OFFICER

DALLAS, TEXAS 75222

December 2, 1987

Circular 87-82

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

SUBJECT

Final rule on amendment to Regulation Z - Truth in Lending

DETAILS

The Board of Governors of the Federal Reserve System has adopted an amendment to Regulation Z which implements a provision of the Competitive Equality Banking Act of 1987 regarding adjustable rate mortgage caps. Effective December 9, 1987, creditors are required to include a limit on the maximum interest rate that may be charged on certain adjustable rate transactions.

ATTACHMENTS

The Federal Register document is attached.

MORE INFORMATION

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

Sincerely yours,

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-0613]

Truth in Lending; Competitive Equality Banking Act

Limitations on Interest Rates

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final rule.

SUMMARY: The Board is revising Regulation Z (the regulation that implements the Truth in Lending Act) to implement section 1204 of the Competitive Equality Banking Act of 1987. Section 1204 provides that, effective December 9, 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 loan. The final rule, incorporating the new law into Regulation Z, limits the scope of section 1204 to dwelling-secured consumer credit, that is subject to the Truth in Lending Act and Regulation Z, in which a creditor may make interest rate changes during the term of the credit obligation -- whether those changes are tied to an index or formula or are within the creditor's discretion. The rule applies the statutory requirement to both closed-end and open-end credit. As a result, effective December 9, 1987, creditors are required to set a lifetime maximum interest rate on all credit obligations secured by a dwelling that require variable-rate disclosures under Regulation Z, where the interest rate may increase. In addition, creditors offering open-end lines of credit secured by a dwelling in which the creditor has the

contractual right to change the interest rate -- the periodic rate and corresponding annual percentage rate -- on an account are also required to set a lifetime maximum interest rate applicable during the plan. The rule applies only to credit obligations entered into on or after December 9, 1987.

Creditors must specify the lifetime maximum rate of interest that may be imposed on obligations subject to section 1204 in their credit contracts (the instrument signed by the consumer that imposes personal liability). Determination of the maximum rate is within the creditor's discretion. Until October 1, 1988, compliance with section 1204 -- specifying the maximum interest rate in credit contracts -- meets the requirement in Regulation Z that creditors disclose limitations on rate increases as part of the variable rate disclosures for open-end credit plans and closed-end credit transactions.

EFFECTIVE DATE: December 9, 1987.

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. 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." (The law 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, including a condominium unit, cooperative housing unit, or mobile home, 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 section is to be treated as a violation of the Truth in Lending Act (TILA); it specifically refers to the civil liability and administrative enforcement provisions of the act, sections 130 and 108, respectively. The law directs the Board to prescribe regulations to carry out its purposes. The law will become effective on December 9, 1987.

Given the broad language of section 1204, most of the questions about the law have concerned the scope of its coverage. On September 15, 1987, the Board published for public comment a proposal to amend Regulation Z to incorporate the substance of section 1204 into the regulation (52 FR 34811). The Board proposed to limit the scope of the statute to adjustable (interest) rate, dwelling-secured consumer credit obligations that are subject to the TILA and Regulation Z -- both open-end and closed-end credit -- entered into on or after December 9, 1987. Therefore, Regulation Z definitions, exemptions, and interpretations would apply to the new rule, where applicable. Under the proposal, creditors would be

required to specify a lifetime interest rate cap in their credit contracts.

The Board received approximately 135 public comments on the proposed amendment. A majority of the commenters agreed with the Board's interpretation of the law's general coverage and the Board's proposed rule for implementing the law. Some commenters disagreed with the Board's interpretation that section 1204 applies to open-end dwelling-secured plans that are not variable rate for purposes of TILA disclosures, but in which the creditor has the contractual right to change the terms of the plan, including the right to make interest rate changes. A small number of commenters questioned whether open-end credit should be covered at all. Some commenters urged limiting coverage to principal dwellings or owner-occupied dwellings. Other commenters suggested that more flexible rules be adopted to allow for changes in a maximum interest rate in certain instances during the term of an obligation. Most of the commenters that opposed the proposal did so because they opposed the law itself, not the Board's proposed rule implementing the law.

Following a further analysis of the law, and analysis of the comments, the Board is now adopting a final rule implementing section 1204. The final rule is much the same as the proposal but reflects some minor revisions. Some editorial revisions have been made to the regulatory text to more closely reflect the language of the statute and to provide more clarity. Footnote 50 has been clarified and expanded to cover both open-end and closed-end credit.

This notice provides guidance on a number of questions asked by commenters. (References are made to various sections of Regulation Z (12 CFR Part 226) and corresponding comments on those sections which are contained in the Official Staff Commentary to Regulation Z (12 CFR Part 226, Supp. I).) Much of this guidance will be incorporated into the seventh update to the staff commentary that will be published for comment in early December.

(2) The amendment to Regulation Z

The Board is adopting a rule amending Regulation Z to incorporate the substance of section 1204 into a new section 226.30 in Subpart D of the regulation. In addition, technical amendments are being made to section 226.1 of Regulation Z, in the paragraphs on authority, organization of the regulation, and enforcement and liability.

Section 226.30 limits the statutory requirement, that a maximum interest rate be set, to dwelling-secured extensions of consumer credit covered by the TILA and Regulation Z in which a creditor may make interest rate changes. Thus, the rule applies only to consumer credit and not business credit. As a result, an adjustable rate business purpose loan is not subject to section 226.30, even if the loan is secured by a dwelling. (See section 226.3(a), and the commentary to that section; see also section 226.2(a)(19) for the definition of a dwelling)

A. Credit obligations subject to section 226.30. Section 226.30 will apply to all closed-end credit transactions and open-end credit plans allowing for interest rate changes during the term of the obligation. As a result, most dwelling-secured

extensions of credit for which Regulation Z variable rate disclosures must be given will be subject to section 226.30. (See section 226.6(a)(2)n. 12 and section 226.18(f); see also comment 6(a)(2)-2 and comments 18(f)-1 and 18(f)-6 for definitions and explanations of variable rate obligations and disclosure requirements) Section 226.30 applies to credit sales as well as to loans.

The following are examples of the types of closed-end transactions or open-end plans that are subject to section 226.30.

- Dwelling-secured open-end lines of credit in which the creditor has the contractual right to make interest rate changes during the plan, even if the adjustments apply to new advances only. (See comment 6(a)(2)-2)
- Renegotiable rate mortgage instruments, described in comment 18(f)-6 as a series of short-term loans where upon maturity the creditor is legally obligated to renew the loan. (The legal obligation of the parties to an extension of credit subject to Regulation Z is determined by applicable state or other law. See generally comments 17(c)(1)-1 and 17(c)(1)-2)
- Multiple advance transactions disclosed as a single transaction, if the interest rate on the advances is unknown at consummation. (See section 226.17(c)(6)(i) and comment 17(c)(6)-1)
- Refinancings as defined in section 226.20(a) -- entered into on or after December 9, 1987 -- of credit

obligations that are dwelling-secured and that allow for interest rate changes

-- Assumptions -- entered into on or after December 9, 1987 -- of credit obligations that are dwelling-secured and that allow for interest rate changes (See generally discussion of assumptions in section F of this notice)

- Credit obligations allowing for interest rate changes to which a security interest in a dwelling is added on or after December 9, 1987
- Dwelling-secured credit obligations to which a variable rate feature is added on or after December 9, 1987

B. Credit obligations not subject to section 226.30. Section 226.30 does not apply to dwelling-secured closed-end transactions and open-end credit plans in which the interest rate may not change during the term of the obligation. Therefore, the following types of transactions or plans are not subject to section 226.30.

- "Shared-equity" or "shared-appreciation" mortgages as described in comment 18(f)-6
- Fixed-rate multiple advance transactions in which each advance is disclosed as a separate transaction
- Fixed-rate balloon payment mortgages that the creditor may, but does not have a legal obligation to, renew at maturity. (The legal obligation of the parties to an extension of credit subject to Regulation Z is determined by applicable state law or other law.) See

generally comments 17(c)(1)-1 and 17(c)(1)-2)

C. Statement of the cap in credit contracts. Creditors will be required to specify in their credit contracts (the instrument signed that creates personal liability) a maximum interest rate (a lifetime cap) that could be imposed on credit obligations. Creditors may comply with the requirement, for example, by attaching an addendum to existing credit contracts, or typing or stamping a provision onto the credit contract, provided that such modifications are deemed part of the legal obligation under applicable state law. Creditors may set the lifetime cap at any amount they choose.

On loans with multiple variable rate features, creditors may establish a maximum interest rate for each variable rate feature or may establish one that will apply to all. For example, in a variable rate loan that has an option to convert to a fixed-rate (which is itself a variable rate feature) a creditor may set a maximum interest rate on each feature (one for the initial variable rate feature and one for the fixed-rate conversion option) or may establish one maximum interest rate applicable to all features.

State law may allow an interest rate after default to be higher than the contract rate; however, the default interest rate may not exceed the maximum interest rate on a credit obligation that is otherwise subject to the requirement of section 226.30.

The maximum interest rate must be stated either as a specified amount or in any other manner that would allow the consumer to easily ascertain, at the time of entering into the

obligation, what the lifetime cap will be over the term of the obligation. 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%.
- The maximum interest rate will not exceed X% or the state usury ceiling, whichever is less.

The following statements 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 never be higher that X percentage points above [a rate to be determined at some future point in time].
- 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 obligation, since choice of a maximum 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 transaction will increase, without stating what the outer limit of an increase in the rate might be. (See example under permissible statements)

A creditor would be in compliance with section 226.30 by stating the maximum interest rate in terms of a maximum annual

percentage rate that may be imposed. Under an open-end credit plan, this would be the corresponding (nominal) annual percentage rate. (See 226.6(a) and 226.7(d))

Under Regulation Z, section 226.19, early TILA disclosures are required for certain closed-end residential mortgage transactions. Although the maximum interest rate set forth in the credit contract under section 226.30 must be stated with certainty, that requirement does not affect the disclosure requirements of section 226.19. Those disclosures may continue to be stated as estimates, where appropriate. (See comment 19(a)-2 and section 226.17(c))

D. **Prospective application**. Section 226.30 does not cover credit obligations entered into prior to December 9, 1987. Consequently, new advances under open-end credit plans existing prior to December 9, 1987 are not subject to section 226.30. Modifications of agreements entered into prior to December 9, 1987 are not covered by section 226.30; however, if a variable rate feature is added on or after December 9, 1987 to a dwelling-secured credit obligation, the obligation becomes subject to section 226.30. If a security interest in a dwelling is added on or after December 9, 1987, to an credit obligation with a variable rate feature, the obligation becomes subject to section 226.30.

In determining whether an obligation is entered into on or after December 9, 1987, the consumer's signing of the instrument that imposes personal liability (which is typically done at closing) governs whether an obligation is subject to the requirement in section 226.30. In some states, the signing of a

commitment letter may create a binding obligation, for example, constituting "consummation" as defined in section 226.2(a)(13) which requires TILA disclosures to be given at that time. In this situation, it is still the actual date of the signing of the loan documents that would govern whether the transaction is subject to section 226.30.

E. Changes in the Maximum Interest Rate Cap. One issue raised by several commenters was whether the required interest rate cap on a loan could be changed during the term of the obligation. For example, they asked whether the maximum interest rate could be changed using the change in terms provision of Regulation Z, section 226.9(c), or whether the maximum interest rate could be changed by the creditor if a consumer and a lender agreed to changes in the terms and conditions of the original open-end or closed-end credit obligation.

The law requires that a maximum interest rate be set for the term of a loan. Under the Board's rule, a creditor would not be permitted to increase the maximum interest rate originally set unless the consumer and the creditor entered into a new obligation. Under an open-end plan subject to section 226.30, a creditor cannot raise the maximum interest rate on the plan by use of a change in terms notice. If a creditor were permitted to use a change in terms notice to increase a maximum interest rate that has been imposed on a plan, the creditor would not, in fact, have set a maximum rate on the plan in accordance with section 226.30.

A new maximum interest rate could be set only if there was a refinancing as defined in section 226.20(a) of Regulation Z

or an open-end plan was closed and a new one opened. Thus, modifications of an existing agreement that do not constitute a refinancing or a new plan do not allow for a change in the maximum interest rate cap set under the original agreement, even if additional credit is extended. If an open-end plan subject to section 226.30 has a fixed maturity and a creditor renews the plan at maturity, without having a legal obligation to do so, a new maximum interest rate may be set at that time.

F. Assumptions. Under the Board's proposal, the assumption of an obligation subject to the new law would allow for a change in the maximum interest rate if the assumption met the test set forth in section 226.20(b). In section 226.20(b) only assumptions of purchase money residential mortgage transactions, in which a creditor formally assents to an assumption in writing, are considered new transactions for purposes of Truth in Lending disclosure. As several commenters pointed out, when a new obligor is substituted for the original party to a credit obligation, it essentially becomes a new loan. Under the final rule, for purposes of section 226.30, where an obligation subject to section 226.30 is assumed and the original obligor is released from liability, the maximum interest rate set on the obligation may be changed as part of the assumption agreement.

G. Truth in Lending Disclosure of Limitations on Increases. Various proposals providing for comprehensive revisions to Truth in Lending Act requirements for closed-end adjustable rate mortgage loan disclosures and open-end home equity lines of credit are currently being considered for Board review. To relieve some

of the burden of making multiple changes in TILA disclosures within a short period time -- should the Board adopt these proposals -- the Board is adopting an interim rule (as footnote 50 to section 226.30). The rule provides that between December 9, 1987 and October 1, 1988 compliance with section 226.30 -- that is, placing the maximum interest rate cap in the credit contract -- will satisfy the Regulation Z requirement, contained in section 226.6(a)(2)n.12 and section 226.18(f)(2), to disclose a limit on rate increases on variable rate closed-end transactions and open-end plans. In other words, no revisions to Truth in Lending disclosure forms to add the limitations on an increase disclosure are required by this amendment to Regulation Z to implement section 1204 of the Competitive Equality Banking Act until October 1, 1988, provided that the requirement in section 226.30 is met.

Transition Rules. In some instances the requirement to give TILA disclosures may not be contemporaneous with the date of signing loan documents. In situations in which TILA disclosures are given before December 9, 1987 and the signing may occur on or after December 9, 1987 -- thus triggering the section 226.30 requirement -- the failure to include a maximum interest rate disclosure in TILA disclosures given at the earlier time would not violate the TILA, provided that section 226.30 is complied with -- that is, the maximum interest rate is stated in the credit contract. (See generally discussion of prospective application in section D of this notice)

H. Creditor's Right to Terminate and Call a Loan Due Solely Because the Maximum Interest Rate Cap is Reached. In its September proposal, the Board expressed concern about the possibility that a creditor might terminate an open-end plan and call the outstanding balance payable in full -- solely because the maximum interest rate cap is reached -- could have an adverse effect on consumers. Since Regulation Z does not currently call for disclosure of this particular right to terminate, the Board solicited comment on whether a creditor that reserves this right should be required to specifically disclose this fact.

A majority of the commenters that responded to this particular issue shared the Board's concern about the right and supported disclosure of the right. A few commenters cautioned that highlighting this one right of termination might encourage the practice or, alternatively, might confuse a consumer into thinking that it is the only reason that an account might be called. Although the Board solicited comment on disclosure of the right, a few commenters went further, to say the right itself was undesirable, and indicated their support for its being prohibited. Although the Board believes that disclosure of this matter should be made, it is not now making it mandatory. Rather, the Board has decided to consider the question of such disclosure as part of a comprehensive proposal for new home equity line disclosures under the TILA that the Board will soon be reviewing. This decision is based on the Board's desire to avoid the unnecessary burden of multiple changes in TILA disclosure forms within a short period of

time, should the Board decide to propose new home equity line disclosures.

(3) Economic Impact Statement.

The Board's Division of Research and Statistics has prepared an economic impact statement on the 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; Rate Limitations; Truth in Lending.

(4) Text of the revisions

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 is amending Regulation Z (12 CFR Part 226) as follows:

PART 226 -- TRUTH IN LENDING

1. The authority citation for Part 226 is revised 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.); sec. 1204(c), Competitive Equality Banking Act, Pub. L. 100-86, 101 Stat. 552.

2. Section 226.1 is amended by revising paragraphs (a), (d)(4) and (e) to 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). Information-collection requirements contained in this regulation have been approved by the Office of Management and Budget under the provisions of 44 USC 3501 et seq. and have been assigned OMB No. 7100-0199.

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

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(4) Subpart D contains rules on oral disclosures, Spanish language disclosure in Puerto Rico, record retention, effect on state laws, state exemptions, and rate limitations.

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(e) Enforcement and liability. Section 108 of the act contains the administrative enforcement provisions. Sections 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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3. A new section 226.30 is added to Subpart D to read as follows:

SUBPART D - MISCELLANEOUS

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Section 226.30 Limitation on Rates

A creditor shall include in any consumer credit contract secured by a dwelling and subject to the act and this regulation the maximum interest rate that may be imposed during the term of the obligation[50] when:

(a) in the case of closed-end credit, the annual percentage rate may increase after consummation, or

(b) in the case of open-end credit, the annual percentage rate may increase during the plan.

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[50] Compliance with this section will constitute compliance with the disclosure requirements on limitations on increases in footnote 12 to section 226.6(a)(2) and section 226.18(f)(2) until October 1, 1988.

By order of the Board of Governors of the Federal Reserve System, dated November 5, 1987.

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