

**FEDERAL RESERVE BANK
OF NEW YORK**

[Circular No. 9332]
[July 30, 1982]

REGULATION Z — TRUTH IN LENDING

Proposals Regarding Seller's Points

*To All Depository Institutions
in the Second Federal Reserve District:*

Following is the text of a statement issued by the Board of Governors of the Federal Reserve System:

The Federal Reserve Board has announced that it is seeking comment on possible changes in the Board's rules concerning ways to deal with seller's points — reduced rate financing — in Truth in Lending disclosures.

The Board requested comment by August 27, 1982.

In revising its Regulation Z (Truth in Lending) last year under the Truth in Lending Simplification and Reform Act, the Board decided, in the interests of providing simple and easily used rules, to exclude seller's points from the finance charge and annual percentage rate (APR) that must be disclosed in credit transactions.

Since then, many financing arrangements have been developed, at a time of unusually high interest rates, for offering consumers financing at rates below rates prevailing in the market. Two such plans are becoming increasingly common where lenders make direct loans to purchasers of homes or other items. One is a "seller's buydown," where a home seller pays an amount to a lender to secure for the buyer of the property a below-market financing rate for the first few years of a long-term mortgage. The other is the "zero percent mortgage rate," where the seller makes a payment to a lender to induce the lender to offer to finance a property without a stated interest rate. This generally calls for a large down payment and total payment within a relatively short time. In either case, the seller must either absorb the payment made to the lender (that is, reduce what the seller is prepared to accept for the property), or increase the price of the property.

If the cost of the property is increased to compensate the seller for the concessionary financing terms that the seller "buys" from the lender, a cost of financing may occur that is not, under the present rules, reflected in the finance charge and APR disclosure. This may impair the buyer's ability to compare the actual purchase price and financing costs of different properties. Similarly, advertising of properties where such below-market financing arrangements are offered may be misleading.

The Board is therefore proposing two alternative methods for dealing with this problem under Regulation Z, and it requests comment on any other possible ways of dealing with seller's points. Both Board proposals would apply to disclosures given for loans to purchase homes or other property where reduced rate financing is involved. Both would apply to the advertising by sellers who provide reduced rate financing, when a rate of interest is advertised.

It should be noted that the Board makes a number of specific requests for comment in the course of describing its proposals.

The Board is planning to make any change in its rules that it may adopt effective as early as feasible. However, the Board requested comment as to how much time would be necessary for creditors to change procedures and forms. The Board asked also whether a different effective date should apply to revised rules for the advertising of reduced rate financing plans.

Enclosed — for depository institutions in this District — is the text of the Board's proposal. It will be published in the *Federal Register*, and will also be furnished upon request directed to our Circulars Division (Tel. No. 212-791-5216).

Comments on the proposed amendments should be submitted by August 27, 1982 and may be sent to our Consumer Affairs and Bank Regulations Department.

ANTHONY M. SOLOMON,
President.

(2) Neither payment nor adequate assurance of payment has been received;

(3) The license applicant has, under provisions of law applicable prior to November 14, 1979, a right to sell, or reclaim and sell, such property by methods not requiring judicial proceedings, and would be able to exercise such right under applicable law, but for the prohibitions in this part, and

(4) The license applicant shall enter into an indemnification agreement acceptable to the United States providing for the applicant to indemnify the United States, in an amount up to 150 percent of the proceeds of sale, for any monetary loss which may accrue to the United States from a decision by the Iran-U.S. Claims Tribunal that the United States is liable to Iran for damages that are in any way attributable to the issuance of such license. In the event the applicant and those acting for or on its behalf are the only bidders on the property, the United States shall have the right to establish a reasonable indemnification amount.

(b) An applicant for a license under this section shall provide the Office of Foreign Assets Control with documentation on the points enumerated in paragraph (a) of this section. The applicant normally will be required to submit an opinion of legal counsel regarding the legal right claimed under paragraph (a)(3) of this section.

(c) Any sale of property licensed under this section shall be at public auction and shall be made in good faith in a commercially reasonable manner. Notwithstanding any provision of State

law, the license applicant shall give detailed notice to the appropriate Iranian entity of the proposed sale or transfer at least 30 days prior to the sale or other transfer. In addition, if the license applicant has filed a claim with the Iran-U.S. Claims Tribunal, the license applicant shall give at least 30 days' advance notice of the sale to the Tribunal.

(d) The disposition of the proceeds of any sale licensed under this section, minus such reasonable costs of sale as are authorized by applicable law (which will be licensed to be deducted), shall be in accordance with either of the following methods:

(1) Deposit into a separate blocked, interest-bearing account at a domestic bank in the name of the licensed applicant; or

(2) Any reasonable disposition in accordance with provisions of law applicable prior to November 14, 1979, which may include unrestricted use of all or a portion of the proceeds, provided that the applicant shall post a bond or establish a standby letter of credit, subject to the prior approval of the Secretary of the Treasury, in favor of the United States in the amount of the proceeds of sale, prior to any such disposition.

(e) For purposes of this section, the term "proceeds" means any gross amount of money or other value realized from the sale. The proceeds shall include any amount equal to any debt owed by Iran which may have constituted all or part of a successful bid at the licensed sale.

(f) The proceeds of any such sale shall

be deemed to be property governed by § 535.215 of this part. Any part of the proceeds that constitutes Iranian property which under § 535.215 is to be transferred to Iran shall be so transferred in accordance with that section.

(g) Any license pursuant to this section may be granted subject to conditions deemed appropriate by the Secretary of the Treasury.

(h) Any person licensed pursuant to this section is required to submit a report to the Chief of Licensing, Office of Foreign Assets Control, within ten business days of the licensed sale or other transfer, providing a full accounting of the transaction, including the costs, any payment to lienholders or others, including payments to Iran or Iranian entities, and documentation concerning any blocked account established or payments made.

(Sec. 201-207, 91 Stat. 1626, 50 U.S.C. 1701-1706; E.O. No. 12170, 44 FR 65729; E.O. No. 12205, 45 FR 24099; E.O. No. 12211, 45 FR 26605; E.O. No. 12276, 46 FR 7913; E.O. No. 12279, 46 FR 7919; E.O. No. 12280, 46 FR 7921; E.O. No. 12281, 46 FR 7923; E.O. No. 12282, 46 FR 7925; and E.O. No. 12294, 46 FR 14111)

Dennis M. O'Connell,

Director, Office of Foreign Assets Control.

Approved:

John M. Walker, Jr.,

Assistant Secretary.

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FEDERAL RESERVE SYSTEM

12 CFR Part 226

[Reg. Z; Docket No. R-0413]

TRUTH IN LENDING

Treatment of Seller's Points

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Proposed rule and proposed revisions to official staff commentary.

SUMMARY: The Board is seeking comment on whether the exclusion of seller's points from the finance charge in reduced rate financing under revised Regulation Z (Truth in Lending) may affect the accuracy of cost disclosures given to the consumer. The Board is publishing for comment two possible alternative methods for the treatment of seller's points, and is asking for comment on other possible methods for dealing with seller's points. Alternative One would remove the current finance charge exclusion for seller's points. Alternative Two would require that a disclosure be given to advise the consumer that the seller has paid money to obtain the financing and that, to the extent the amount has been passed on to the consumer in the form of a higher sales price or other charge, the annual percentage rate and other disclosures understate the cost of credit.

DATE: Comments must be received on or before August 27, 1982.

ADDRESS: Comments may be mailed to the Secretary, Board of Governors of the Federal Reserve System, Washington, D.C. 20551, or delivered to Room B-2223, 20th & Constitution Avenue, N.W., Washington, D.C., between 8:45 a.m. and 5:15 p.m. weekdays. Comments may be inspected in Room B-1122 between 8:45 a.m. and 5:15 p.m. weekdays. All material submitted should refer to Docket No. R-0413.

FOR FURTHER INFORMATION CONTACT: Clarence B. Cain or Gerald P. Hurst, Staff Attorneys, Division of Consumer and Community Affairs, Board of Governors of the Federal Reserve System, Washington, D.C. 20551, (202) 452-2412 or (202) 452-3667. Regarding the initial regulatory flexibility analysis, contact: Fred B. Ruckdeschel, Economist, Regulatory Improvement Project, Board of Governors of the Federal Reserve System, Washington, D.C. 20551, (202) 452-2579.

SUPPLEMENTARY INFORMATION: (1) General. The Truth in Lending Act defines finance charges to include "all charges, payable directly or indirectly by the person to whom the credit is extended, and imposed directly or indirectly by

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SUPPLEMENTARY INFORMATION: (1) General. The Truth in Lending Act defines finance charges to include "all charges, payable directly or indirectly by the person to whom the credit is extended, and imposed directly or indirectly by the creditor as an incident to the extension of credit." ^{1/} Under old Regulation Z, ^{2/} the Board took the position that if a lender imposed points on the seller and the points were in fact passed on to the buyer, the lender had to include them in the finance charge and in computing the annual percentage rate (APR) disclosed to the borrower. The typical situation involved VA and FHA loans which allowed only one point to be passed on to the buyer; the remainder had to be paid by the seller. Some conventional transactions also involved points to be paid by the seller. Since it was difficult for a lender to determine whether a seller had increased the sales price--and, if so, by how much--lenders generally made a presumption and either included the points in the finance charge or excluded them in all cases.

In revising Regulation Z (46 FR 20848, April 7, 1981) under the Truth in Lending Simplification and Reform Act (Title VI of the Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. 96-221, March 31, 1980), the Board sought to provide precise, simple rules as opposed to general statements that created ambiguity, required additional regulatory clarification and tended to generate litigation on technicalities. Applying this principle to the seller's points question, the Board decided to exclude them from the finance charge in all cases, even if they were passed along to buyers in a higher sales price. ^{3/} This rule eliminated guess work for lenders trying to determine if some or all of the points had been added to the sales price. The change was also based on the belief that the purchaser would understand that the sales price might be adjusted if the lender imposed charges on the seller.

Since the amendment of the regulation, an increasing number of financing arrangements have been developed that offer the consumer below-market financing. These arrangements have been developed to offer the buyer lower monthly payments or to qualify the buyer at a lower interest rate. A number of interested parties have questioned whether the seller's points rule applies to specific financing arrangements. Some have expressed concern that creditors have an opportunity to significantly understate the APR.

When lenders make direct loans to purchasers of goods, two types of reduced rate financing are becoming increasingly common: "seller buydowns" and "zero percent mortgages." In a typical "seller buydown," a home seller pays a

^{1/} Section 106(a) of the Truth in Lending Act, 15 USC 1605.

^{2/} 12 CFR 226.406.

^{3/} Section 226.4(c)(5) of revised Regulation Z. Comment 4(c)(5)-1 of Official Staff Commentary, TIL-1, provides that the exclusion from the finance charge applies to "any charges imposed by the creditor upon the non-creditor seller of property for providing credit to the buyer or for providing credit on certain terms."

lender to buy down the interest to a below-market rate for the first few years of a long-term mortgage. The lender recognizes that some buyers' incomes will rise in the future and thus is willing to qualify these borrowers because they can afford the lower initial payments and are likely to be able to afford higher payments later. In a zero percent mortgage arrangement, a seller of homes makes a payment to a lender to induce the lender to offer a short-term zero interest mortgage to a purchaser. The seller generally requires a large downpayment in such cases. The seller must either absorb the payment made to the lender as a cost of selling, increase the price for all its purchasers, or increase the price for only those purchasers using the special financing.

Under the rule in revised Regulation Z, to the extent these credit arrangements result in a higher sales price to customers using these financing plans, a cost of credit is removed from the loan disclosures. Under the present rule the cost attributable to the buydown or points does not have to be reflected in the finance charge or APR, and this may impair the consumer's ability to shop. Two examples will demonstrate the impact on the APR.

One involves a house with a sales price of \$50,000 and a loan of \$40,000 at a 16% contract rate. The seller offers a 3-year buydown at 13% and the cost of the buydown (\$3,626.00) is included in the sales price. The term of the loan is 30 years and it is repayable in 36 payments of \$442.48 and 324 payments of \$535.32. If the amount of the buydown is excluded from the finance charge, the APR is 14.87%. If the amount of the buydown is treated as a pre-paid finance charge, however, the APR would be 16.34%.

A second example involves a zero percent mortgage transaction on a home valued at \$40,000. The home seller agrees to pay to a financial institution \$9,500 if the institution will make a \$30,000 zero percent mortgage. The \$9,500 is added to the sales price, so the price to the buyer becomes \$49,500. The buyer pays the seller \$19,500 and is charged two points (\$600) by the lender. The loan is paid in 60 payments of \$500 each. If the \$9,500 paid by the seller is excluded from the finance charge, the APR is 0.8%. If the \$9,500 is treated as a prepaid finance charge, however, the APR would be 17.5%.

One concern about the current rule is that it may permit the advertising of misleading APRs for various financing arrangements. As set forth in the official staff commentary (46 FR 50288, October 9, 1981), sellers or creditors may promote the availability of financing plans involving buydowns by advertising the reduced ("bought down") simple interest rate.^{4/} The advertisement, however, must also show the limited term to which the reduced rate applies, the simple interest rate applicable to the balance of the term, and the overall APR. Where the buydown is large, so that the simple interest rate is significantly less than the prevailing market rate, the APR being advertised could be misleading as to the real cost of the financing.

The Board is therefore proposing two alternative actions for the treatment of seller's points under revised Regulation Z. The Board also asks for comment on other possible ways of dealing with seller's points.

^{4/} Comment 24(b)-3 of Official Staff Commentary, TIL-1.

(2) Alternative One. This proposal would remove § 226.4(c)(5) from the regulation and provide that: (1) seller's points when passed on only to buyers taking advantage of a financing arrangement are finance charges, (2) only the amount of the seller's points actually passed on need be considered a finance charge, and (3) if the creditor is unsure whether the seller's points are being passed on, or is unsure of the amount being passed on, the entire amount of the seller's points may be included in the finance charge and reflected in the APR. The Board specifically seeks comment on the probable effect of this rule.

This alternative is based on the premise that the cost of financing has become such an important factor in the marketplace for consumers facing the prospect of a major purchase that they should have a simple yardstick for comparing the costs of various sources of credit. Under the Truth in Lending Act, the APR is intended to function as such a yardstick. Without a single figure for comparison, even if consumers understand that some credit costs may be included in the sales price, it may be difficult for them to compare the true financing cost of a purchase involving a reduced rate financing plan with the cost of the purchase involving financing from other sources.

Determining the extent to which a seller has passed on points to a buyer as part of the sales price requires the lender to know the price that the buyer would have paid in a cash transaction (or with financing that the seller did not buy down). The Board is aware of the longstanding problem of how to determine the "cash price" of goods, particularly if there are few cash buyers, the product sold is unique, and/or prices are customarily subject to negotiation. On the other hand, although it may be difficult to identify the true cash price in some cases, in many instances the parties offering reduced rate financing plans have a clear idea about how much "adjustment" to the cash price has taken place to offset the seller's payment to the lender and can readily make the computations necessary for a complete disclosure. Because of the difficulties in other situations, however, the proposed changes to the official staff commentary under Alternative One would specifically permit creditors to assume that all seller's points are paid by the buyer.

Alternative One would cause some overstatement of the APR where the seller's points have not been passed on entirely and the creditor includes the entire amount in the finance charge. However, total exclusion of seller's points from the finance charge could lead to a more substantial understatement of the APR, for example, in zero percent mortgage transactions. The overstatement would be allowed under this alternative because of the practical problems of determining the precise amount of seller's points actually passed on and the potential for litigation without the added flexibility. Although creditors and sellers would be permitted to overstate the APR, there would be an incentive to determine the amount that is actually passed on in order to avoid having to overstate the APR in advertisements and disclosures for reduced rate financing programs. The Board seeks comment on the effect of allowing the overstatement of the APR, including whether significant overstatements would result.

The question has arisen whether adopting Alternative One will prevent sellers from offering "seller buydowns," "zero rate financing," or other reduced rate financing plans. It is expected that sellers could continue to offer the

programs and advertise "bought down" rates; the only change would be that if a bought down rate (reduced simple interest rate) were disclosed, the APR disclosed in the advertisement would have to reflect any seller's points that are passed on only to customers using a financing arrangement. The Board seeks comments on whether this change is likely to discourage the offering of reduced rate financing.

Alternative One would not require creditors to change their forms. However, it would require a change in procedures and retraining of personnel. The Board requests comment on the costs that would be associated with the adoption of this alternative.

If the Board adopts Alternative One, removing § 226.4(c)(5) from the revised regulation, staff proposes to make the following changes in Official Staff Commentary, TIL-1:

- Comment 4(b)(3)-2 would be added to explain how to treat seller's points under the amended finance charge provisions.
- Comment 4(c)(5)-1 would be removed since its regulatory basis would no longer exist.
- Comments 17(c)(1)-3 and 17(c)(1)-5 would be completely revised to reflect the possibility that an amount paid by a seller may be a finance charge.

(3) Alternative Two. This alternative would continue to exclude seller's points from the finance charge but would require a new disclosure concerning seller's points in disclosure statements and advertisements for reduced rate financing transactions. A creditor would be required to state (1) that the seller has paid money to obtain the financing; (2) the amount paid; and (3) that the payment, to the extent it has been passed on to the consumer in the form of a higher sales price or other charge, results in a higher cost of credit than that actually disclosed. The requirement would be added by amending the regulation as follows:

- Section 226.18, "Content of Disclosures," would be amended by adding a new paragraph (s), requiring the disclosure of charges paid by the seller to the creditor for providing credit to the buyer or for providing credit on certain terms.
- Section 226.24(b), "Advertisement of Rate of Finance Charge," would be amended by rearranging the current paragraph and adding a new paragraph (b)(3) stating the new seller's points disclosure requirement.
- Section 226.24(c), "Advertisement of Terms That Require Additional Disclosures," would be amended by adding a new paragraph (c)(2)(iv) stating the new seller's points disclosure requirement.
- Footnote 38 to § 226.17(a)(1), "Form of Disclosures," would be amended to permit the new seller's points disclosure under § 226.18(s) to be made apart from other required disclosures.

- Appendix H, "Closed-end Model Forms and Clauses," would be amended by adding a Seller's Points Model Clause as H-16.

This alternative avoids some of the problems created by Alternative One, such as the difficulty in determining whether and to what extent seller's points are included in the sales price to only those customers taking advantage of a specific financing arrangement. At the same time, the disclosure would put the consumer on notice that the stated APR and finance charge may not accurately reflect overall credit costs.

However, this alternative may also create problems. For example, the disclosure could result in confusion on the part of consumers and difficulties for creditors and sellers in explaining the meaning of such a disclosure. In addition, the imposition of a new disclosure requirement could require creditors to reprint forms or print a separate form in order to make the disclosure, giving rise to significant costs for creditors and sellers engaged in offering reduced rate financing. Both of these considerations could result in restricting the use of reduced rate financing.

Another concern is the broad coverage of this disclosure requirement. Alternative Two may well affect more transactions than Alternative One. Specific comment is solicited as to the number or percentage of transactions affected and the cost of these new requirements.

Although the headings of the provisions in the regulation would use the term "seller's points," the disclosure requirements would not be phrased in terms of "seller's points" nor would the actual disclosures be phrased in those terms. (See proposed Model Clause H-16.) Use of the term "seller's points" could confuse consumers and creditors, since traditionally "seller's points" have been viewed as a percentage amount of the loan transaction payable by the seller while the term under revised Regulation Z has come to have a broader meaning. Instead, the language of the disclosure requirements and the disclosures would be descriptive, that is, referring to a charge that is paid by a seller in order for the creditor to extend credit to the buyer or extend credit on certain terms. This is the same as the meaning given the term "seller's points" in current Comment 4(c)(5)-1 of the official staff commentary.

The new disclosure required in the disclosure statement could be made along with the other segregated disclosures (in the so-called "federal box") or elsewhere. This position is reflected by the proposal to add a reference to the seller's points disclosure to footnote 38 to § 226.17(a)(1). This relaxation of the rule that all required disclosures must appear together would allow creditors to use their existing disclosure statements and put the new disclosure elsewhere.

Alternative Two is not intended to require the new disclosure for charges that do not rely on the exclusion from the finance charge for seller's points in § 226.4(c)(5) of the regulation. Examples of charges that are intended to be excluded from this disclosure requirement are:

- Commitment fees. These are sums generally paid by a developer or builder of a development such as a multiple-unit building to

obtain financing for a number of sales transactions; they are not tied to specific transactions and do not result in a higher sales price for customers taking advantage of offered financing; as a result, they would not be finance charges under § 226.4(a) of the regulation. See Comments 4(a)-1 and -2.

- Discounts on credit obligations when they are sent to the creditor for payment or assigned by a seller-creditor to another party as long as the discount is not separately imposed on the consumer. (These charges do not constitute finance charges under § 226.4(a) of the regulation. See Comment 4(a)-2.)

In order to avoid confusion on this point, the discussion of seller's points in Comment 4(c)(5)-1 would be modified to make clear that charges that are otherwise not finance charges are not included in the concept of seller's points for purposes of Regulation Z. The Board specifically requests comment on the need for this change in connection with Alternative Two and whether the suggested changes in the language of Comment 4(c)(5)-1 would accomplish the desired result.

The Board would like comment on Alternative Two and whether there is another way to disclose the existence of seller's points and their effects without imposing significant burdens on creditors. In addition, the Board requests comment as to the form a seller's points disclosure should take; whether the disclosure in an advertisement should be the same as or briefer than that in the actual disclosure statement; and whether the disclosure requirement should be limited to advertising. The Board requests specific comment as to whether or not in advertisements the creditor should be allowed to merely state that an amount has been paid by the seller, rather than showing the specific amount paid.

If the Board adopts Alternative Two, requiring disclosure of seller's points, staff proposes to make the following changes to Official Staff Commentary, TIL-1:

- Comment 4(c)(5)-1 would be revised to clarify the treatment of commitment fees and other items and to include a reference to the new disclosure requirements found in §§ 226.18(s) and 226.24(b)(2) and (c)(2)(iii) of the regulation.
- Comment 17(c)(1)-3 would be revised to include a reference to the new disclosure requirement for seller's points.
- Comments 18(s)-1 and -2 would be added to discuss the seller's points disclosure in § 226.18(s).
- Comments 24(b)-1, -2, and -3 would be rearranged and redesignated to reflect the regulatory revisions to § 226.24(b). In particular, Comment 24(b)(3)-1 would be added to explain the new advertising requirement.
- Comment 24(c)(2)-5 would be added to explain the new advertising requirement in § 226.24(c)(2)(iv).

- Comment H-17 would be added to discuss new model clause H-16 for seller's points.

The Board also requests comment as to other actions in lieu of Alternatives One and Two that could be taken to reduce any potential for misleading consumers as to the true cost of credit that currently exists with the seller's points rule. In particular, the Board is interested in actions that would not significantly restrict the availability of reduced rate financing. The reason for proposing action in the seller's points area, as mentioned previously, is to maintain the usefulness of the APR as a tool in shopping for credit by ensuring that consumers can understand and compare alternative financing arrangements.

Because the proposed amendment requires prompt action in the public interest, the Board finds it is not necessary to follow the expanded rulemaking procedure set forth in the Board's policy statement of January 15, 1979 (44 FR 3957). Instead, the Board finds that a 30-day comment period is sufficient.

(4) Effective Date. If Alternative One or Alternative Two is adopted, the change would be effective as soon as is feasible. The Board solicits comment as to a date that would be considered feasible. Comment is requested on whether the effective date for advertisements should be earlier than that for disclosures.

(5) Initial Regulatory Flexibility Analysis. This analysis is designed to meet requirements of the Regulatory Flexibility Act and to assist the public in responding to the proposals introduced earlier in this Federal Register notice. These proposals are a response to concerns expressed by certain parties that consumers may be misled by the reduced-rate financing plans now commonly being used in the market for new housing. This analysis presents the problem of determining the cost of credit when seller's points are involved, discusses possible benefits and costs of the two proposals, highlights potential problems and areas in which the Board specifically requests comment, and outlines other alternatives to the proposals.

Function of Truth in Lending. There are two primary consumer protection goals of Truth in Lending. These goals are to be achieved by disclosure of credit costs, especially the annual percentage rate (APR) and the finance charge. The first goal, called the "shopping function" by the National Commission on Consumer Finance, is to improve consumers' ability to make comparisons by providing a uniform method of stating credit costs. The second goal, called the "descriptive function", is to improve consumers' ability to decide whether to use credit or cash to finance a purchase or to delay consumption and finance the purchase later out of savings. In the discussion that follows, the shopping and descriptive functions will serve as a basis for evaluating the effectiveness both of new Regulation Z and of the alternative proposals in dealing with seller's points.

Problem with seller's points. When the purchase of a product, such as a house, and a credit transaction are tied together, disclosure of accurate and consistent information can be complicated in advertising, in negotiations setting sales terms, and in credit documents. The price of the product and the costs of acquiring it with credit can be identified as separate cost components

only when the product and the credit package can be chosen independently of each other. With reduced-rate financing, a seller pays a creditor to charge the buyer a below-market interest rate on the financing used to purchase the product. The seller might be able to recoup some portion or all of that payment in the price paid by the buyer. Thus, the item being purchased and the reduced-rate financing are "packaged" together. Accordingly, the price of the item being purchased and the interest rate on the financing are mathematically related. The problem, then, is to determine what, if any, amendments to Regulation Z will assist consumers in directing their search efforts or improve their ability to choose the best deal when products and financing are packaged together.^{5/}

Proposed alternatives.

Alternative One provides two distinct methods for creditors to use when calculating the APR, the finance charge, and the amount financed, all three of which are terms defined in Regulation Z.

The first method requires the creditor to calculate the amount financed by deducting from the amount of the loan the portion of any seller's points that is passed on to a buyer in a higher sales price, to add that portion of points to the finance charge, and to treat those passed-on points as a prepaid finance charge when calculating the APR being paid on the amount financed.

The second method allows the creditor to subtract the entire amount of seller's points from the loan to calculate the amount financed, whether the points are passed on entirely, partly, or not at all. That entire amount is also added to the finance charge and is treated as a prepaid finance charge when calculating the APR.

Alternative One also requires that a seller's advertisements use one or the other of those APRs when any interest rate is advertised.

Alternative Two calls for creditors on their disclosure statements and for sellers in their advertisements (1) to show the amount a seller has paid to the creditor so that buyers may obtain the reduced-rate financing and (2) to state that the seller's payment, to the extent that it has been passed on to the consumer in the form of a higher sales price or other charge, results in a higher cost of credit than is actually disclosed. The Board requests specific comment on whether a statement that an amount has been paid would be sufficient in advertisements without identifying a dollar amount.

^{5/} In transactions involving seller's points, consumers may also face complications unrelated to Truth in Lending. In particular, seller's points may have three types of tax implications. First, whether or not points are passed on, use of reduced-rate financing might affect the proportion of monthly payments that may be deducted from gross income in the computation of taxable income. Second, seller's points may affect the cost basis used in the computation of capital gains for tax purposes. Third, to the extent seller's points are passed on in the price of real property, points may result in a higher assessment of property for tax purposes than would otherwise occur.

Analysis of Alternative One.

Disclosures. The following examples illustrate how the TIL disclosures would appear under both new Regulation Z and Alternative One.

In Example One the buyer obtains a \$40,000 loan for 30 years, with a 13 percent interest rate for 3 years and a 16 percent interest rate for the remaining 27 years. In order to induce the creditor to offer the reduced rate for three years, the seller pays the creditor \$3,626.

Example One

	<u>Annual Percentage Rate</u>	<u>Finance Charge</u>	<u>Amount Financed</u>	<u>Total of Payments</u>
New Regulation Z	14.87%	\$149,372.96	\$40,000.00	\$189,372.96
Alternative One (Entire \$3,626 of points treated as prepaid finance charge)	16.34%	\$152,998.96	\$36,374.00	\$189,372.96

In Example Two the buyer obtains a \$30,000 zero-percent loan with a maturity of 5 years. The buyer pays \$600 of points directly to the creditor, and the seller pays \$9,500 of points to the creditor in order to induce it to offer the reduced-rate financing.

Example Two

	<u>Annual Percentage Rate</u>	<u>Finance Charge</u>	<u>Amount Financed</u>	<u>Total of Payments</u>
New Regulation Z	0.8%	\$ 600.00	\$29,400.00	\$30,000.00
Alternative One (Entire \$9,500 of points treated as prepaid finance charge)	17.5%	\$10,100.00	\$19,900.00	\$30,000.00

Note that the total of payments are identical in the two disclosures shown for each example -- \$189,372.96 and \$30,000, respectively. This is so because the scheduled monthly payments are unchanged. What differs is the apportionment of the total of payments between principal (amount financed) and interest (finance charge). And apportionment affects the calculation of the APR.

Relationship between price and interest rate. The TIL disclosures, in the examples above, show only financing costs and do not mention product price and downpayment. But, when the product being purchased and the financing

are packaged together, the stream of payments made by a buyer is consistent with an infinite number of price and interest rate combinations. This section discusses the simultaneous relationship between price and interest rate in transactions where product and financing are tied together.

When the downpayment on a house and the monthly payments on the loan and its maturity are established, a price can be set; and the interest rate is determined automatically by a mathematical formula. Alternatively, an interest rate can be set, and the price is determined automatically. The mathematics is the same as that used in calculating the prices and yields of debt securities.

In Example One, where the interest rate is bought down to 13 percent for three years, the downpayment is \$10,000; and the monthly payment for the first three years is \$442.48 and for the next 27 years is \$535.32. With the contract purchase price set at \$50,000, the annual percentage rate is 14.8 percent. Alternatively, when the \$3,626 of seller's points is treated as a prepaid finance charge, then the annual percentage rate is 16.34 percent; and the implied price of the house is \$46,374, which is \$3,626 less than the contract purchase price.

In the example with a zero interest rate, in which points are assumed to be passed on to the consumer through a higher price, the downpayment is \$19,500; points paid by the buyer to the creditor are \$600; and the monthly payment for 60 months is \$500. When the interest rate is stated to be zero percent, the price is \$49,500. But when the seller's \$9,500 payment to the creditor is treated as a finance charge rather than as part of the price, the implied price is \$40,000; and the APR stated in the TIL disclosure is 17.5 percent.

In fact, in any given transaction with any given downpayment, any one of an infinite number of price and interest-rate combinations accurately reflects the specific monthly payment and maturity terms. Each combination depends on how much of the price is treated as a prepaid finance charge and is deducted from the amount financed. Since the amount of financing plus the downpayment equals the price of a house, any deduction from the amount financed implies a reduction in price. The issue with seller's points, then, can be viewed as a question of how to apportion the total of payments involved in the financing between the amount financed and the finance charge. Thus when a regulatory requirement apportions less than the contractual amount of the loan to the "amount financed" in a Truth in Lending disclosure, a reduction in the price of the house is implied.

Alternative One, in effect, stipulates two methods of determining which of the multitude of rates will satisfy the advertising and disclosure requirements of Regulation Z. One method requires estimating the proportion of the seller's points that is passed on to the consumer and thus is treated as a prepaid finance charge in the calculation of TIL disclosures. The other method permits the entire amount of points to be treated as a prepaid finance charge.^{6/}

^{6/} By providing two methods for calculating the finance charge and the APR, Alternative One weakens the shopping function of Truth in Lending. When creditors do not use the same method, the TIL disclosures will not be comparable.

Significant economic impacts of Alternative One. Under the shopping goal of Truth in Lending, disclosure of credit costs on a comparable basis provides two benefits. First, disclosure increases the efficiency with which consumers use advertising to search for options. Second, it increases the efficiency with which consumers compare options. The treatment of seller's points in new Regulation Z can adversely affect consumers' search for options when all or a large portion of seller's points are passed on in a higher price. The bought-down APR can be advertised but the inflated price need not be. Thus, consumers may be induced through advertisements to spend scarce shopping time and effort gaining further information about deals that, upon comparison, turn out to be more costly. Alternative One would help remedy this problem when all or a large portion of points are passed on.

Alternatively, when a seller does not pass on points by raising price or passes on only a small portion, then advertising of interest rates under new Regulation Z shows that the seller is willing to reduce the total cost of a transaction through subsidized financing. Under Alternative One, when creditors assume, contrary to fact, that seller's points are passed on, advertised interest rates would not reflect the interest-rate subsidy. Thus, under these circumstances, Alternative One would reduce consumers' ability to use advertising to direct their search efforts.

In order to assess the ultimate impact on the search process, it is necessary to take into account (1) the extent to which sellers are likely to pass on points to consumers and (2) the impact that Alternative One is likely to have on the behavior of creditors.

Little information is available to the Board on the extent to which sellers have been able to pass on points to consumers. However, under current economic conditions sellers may not be able to increase prices sufficiently to pass on a large portion of the seller's points. Thus, the Board seeks information on this question.

The impact of Alternative One on sellers' and creditors' behavior is likely to arise from possible increases in costs in three areas. First, there are the costs of training personnel to treat all or part of seller's points as a prepaid finance charge. Second, there are costs of estimating the cash prices necessary to determine what portion of those points have been passed on to buyers in higher prices.^{7/} Third, and potentially most important, there is the cost to sellers and creditors that takes the form of an increased risk of litigation brought against them by consumers who claim that the passed-on portion of seller's points was underestimated. Many sellers and creditors are likely to avoid the second and third kinds of cost by including the full amount of the points in the finance charge or by overestimating the portion of points

^{7/} Included here would be the cost to creditors of monitoring the extent to which negotiations between sellers and buyers have changed the characteristics of the houses being sold. For example, negotiated changes in landscaping, appointments, and other details, as well as settlement dates could affect the hypothetical cash price that the creditor must estimate.

passed on, whenever the cash price is not obvious. To the extent costs in these areas are incurred, creditors can be expected to attempt to recover them through higher interest charges.

When seller's points are not passed on entirely and creditors choose to avoid the cost of estimating the amount of seller's points passed on and the risk of litigation, consumers may be misled in their search activities under Alternative One. Advertised APRs for subsidized financing would be as high as market interest rates. As a result, this alternative may impair consumers' ability to identify lower cost alternatives by comparing advertisements.

Following the search effort the consumers will attempt to choose the best combination of product and financing. The terms of the sales contract and the new Regulation Z disclosures provide sufficient information for consumers to make informed financial decisions. The total cost of each possible transaction is fully reflected either by the price and bought-down APR or the down-payment and monthly payments (assuming contract maturity and downpayment percentage are constants). However, when seller's points are treated as a prepaid finance charge under Alternative One, a reduction in price is implied, as noted in the discussion of the mathematical relationship between price and interest rate. But without knowing the implied price, the consumer will see the points double counted. That is, the points will be reflected in both the disclosed APR and in the contract price. As a result, consumers who rely on the proposed disclosure would overestimate the total cost of the transaction. Requiring disclosure of the implied price would remedy this deficiency in Alternative One. But an additional disclosure would conflict with a Board objective in simplifying Regulation Z.

The attached Appendix A has two examples illustrating some of the information that would be disclosed in the sales contract and in the credit documents under new Regulation Z and Alternative One.

In summary, Alternative One requires APRs and finance charges to be restated to reflect the amount of seller's points passed on. Whenever seller's points are largely or completely passed on, Alternative One prevents consumers from being misled by advertisements during their initial search for attractive combinations of product and financing arrangements. But, when seller's points are not passed on, as perhaps during times of economic distress, then the impact of Alternative One, through advertising, on consumers' search efforts depends on whether creditors and sellers choose to estimate the amount of points passed on or choose to treat the entire amount of points as a prepaid finance charge. When they treat the entire amount as a prepaid finance charge, the APRs for subsidized financing will appear the same as those for unsubsidized financing. Consequently, consumers might have greater difficulty in searching for deals with subsidized financing.

Whether or not points are passed on, Alternative One could cause consumers confusion. Consumers would not know whether the APR reflected an estimate of points passed on or a cost-minimizing arbitrary inclusion of the full amount of points by the creditor. In addition, since the restated APR and

price both reflect the points, they are double counted. This could affect consumers' ability to compare deals and their decision whether to finance a purchase with credit or liquid assets or to delay the purchase and save.

The Board seeks empirical and analytical information on these and other possible impacts of Alternative One on consumers, creditors, and sellers.

Analysis of Alternative Two.

As described earlier, the warning statement required by Alternative Two tells consumers the dollar amount of seller's points paid to the creditor and that the cost of credit is higher than that disclosed to the extent that points have been passed on to the buyer. Alternative Two has important implications for consumers. First, it would lead consumers to doubt the usefulness of TIL disclosures, since the disclosure requirements of Alternative Two state that important information may not be taken into account in calculating the APR and finance charge, specifically, the amount of points paid by a seller. That doubt might undermine consumers' confidence in the process of obtaining credit. Nevertheless, the presence of a warning may induce consumers to devote greater attention to the details of reduced-rate financing plans. Second, disclosure of the dollar amount of points would not give consumers adequate information to determine whether the seller has subsidized the financing or has passed on the points in product price. In order to obtain this information, the consumer would have to compare various packages of price and annual percentage rate, which is the same task that the consumer performs when directly evaluating the costs of alternative product and financing combinations. Thus, disclosure of the dollar amount of points would not improve consumers' ability to compare deals but would introduce further complexity to Truth in Lending disclosures.

Alternative Two would impose some additional paperwork burdens on creditors. The Board recognizes that advertising copy would have to be different. The Board seeks information whether Alternative Two is likely to discourage interest rate advertising by sellers or have any other impact on advertising practices. Creditors' forms also would need to be reprinted or overprinted with the statement about the seller's payment. A long lead time before any amendment would take effect would minimize the impact of changes in forms. Documented estimates of such printing costs would be helpful to the Board's consideration of the issue.

In summary, Alternative Two would alert consumers that the below-market financing cost might be accompanied by a correspondingly higher product price. This lack of definitiveness may lead consumers to question the value of the TIL disclosures. Moreover, disclosure of the dollar amount of seller's points, as required by Alternative Two, does not improve consumers' ability to determine whether financing is subsidized or points have been passed on.

The Board seeks empirical or analytical information about whether the disclosure in Alternative Two would be effective in alerting consumers or would itself be confusing or misleading.

Other aspects of the analysis.

Necessary professional skills. Creditors and sellers may need certain accounting, marketing, or other skills to estimate how much of any seller costs are passed on to a buyer. The Board seeks information about what skills might be necessary or desirable for making those estimates.

Impact on small businesses. Neither requirement would appear to have a seriously disproportionate impact on small creditors or small sellers of new homes.

Significant alternatives to the proposals. The Regulatory Flexibility Act calls for a description of alternatives to proposed rules. The Board will entertain specific comment on any of the three alternatives given below or other proposals for dealing with seller's points.

(a) As a substitute for Alternative Two, require a statement indicating only that the contract price, rather than the APR, may reflect any points passed on. The statement could read as follows: "Costs to the seller of this financing are not reflected in the APR and may instead be included in part or entirely in the purchase price." This alternative would avoid the possibly misleading disclosure of the dollar amount of points. More important, it would alert consumers to the need to consider price and APR simultaneously when shopping for purchases that combine the house and reduced-rate financing in a single package.

(b) Require the statement in (a) to be shown only in advertisements and not on the disclosure statement. This modification of (a) would alert the consumer during the primary shopping effort and avoid the burden of disclosure after most shopping effort has been expended.

(c) Retain the current treatment of seller's costs for reduced-rate financing, recognizing (1) that the APR and price reflect each other when downpayments, monthly payments, and maturities are already specified and (2) that a multitude of APR and price combinations are mathematically consistent. Consumers must consider all costs revealed during negotiations and disclosed in the credit and sales documents when comparing alternatives that package the product with reduced-rate financing. To the extent that seller's points are passed on, they will be reflected in a higher price, higher downpayment, higher monthly payment, less desirable house, or some combination of these elements.

Appendix A--Shopping Examples. Here are two "realistic" examples of deals that a consumer might face when shopping for a home.

Example A is one used earlier, in which the seller buys down the interest rate to 13 percent for three years. Negotiation of the sales contract or the contract itself shows the following:

(a) Price	\$	50,000.00
(b) Downpayment	\$	10,000.00

The TIL disclosure statement would show the following:

	<u>Under new Reg. Z</u>	<u>Under proposed Alternative One</u>
(c) APR	14.87%	16.34%
(d) Finance charge	\$149,372.96	\$152,998.96
(e) Amount financed	\$ 40,000.00	\$ 36,374.00
(f) Total of payments	\$189,372.96	\$189,372.96
(g) Monthly payments	36 at \$442.48 each and 324 at \$535.32 each	36 at \$442.48 each and 324 at \$535.32 each
(h) Prepaid finance charge (shown on a separate written itemization of the amount financed)	...	\$3,626.00

Example B represents the negotiated terms of the sale of a house that is essentially the same to the buyer as the house in Example A. The seller is willing to sell for \$48,000 rather than \$50,000 as in Example A. The same bought-down financing is provided and because of the lower price, a smaller downpayment is required.

(a) Price	\$	48,000.00
(b) Downpayment	\$	8,500.00

The TIL disclosure statement would show the following:

	<u>Under new Reg. Z</u>	<u>Under proposed Alternative One</u>
(c) APR	14.87%	16.34%
(d) Finance charge	\$147,506.32	\$151,086.97
(e) Amount financed	\$ 39,500.00	\$ 35,919.35
(f) Total of payments	\$187,006.32	\$187,006.32
(g) Monthly payments	36 at \$436.95 each and 324 at \$528.63 each	36 at \$436.95 each and 324 at \$528.63 each
(h) Prepaid finance charge (shown on a separate written itemization of the amount financed)	...	\$3,580.65

The creditor in Example B believes that approximately \$2,250 in points were actually passed on in a higher price, since the seller said that \$45,750 would probably have been accepted from a buyer with cash or other financing. The creditor chose to avoid the risks of litigation under Alternative One and disclosed the APR based on the assumption that all points had been passed on (as shown above). The APR based on only \$2,250 being passed on would have been 15.77 percent.

Under both Examples A and B, the APRs would be the same calculated under new Regulation Z or under proposed Alternative One. The purchase decisions will be based on the different purchase price and the lower downpayment and monthly payments that are the result of the lower price. The question is whether the 16.34% APR or the 14.87% APR is the more nearly accurate statement of the cost of credit.

List of Subjects in 12 CFR Part 226

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

(6) Alternative One--Amendments to the Regulation and Official Staff Commentary. Pursuant to the authority granted in § 105 of the Truth in Lending Act (15 U.S.C. 1604) as amended by Pub. L. 96-221, 94 Stat. 170 (March 31, 1980), the Board proposes to amend § 226.4 of Regulation Z (12 CFR Part 226) by removing paragraph (c)(5) and redesignating paragraphs (c)(6), (7), and (8) as (c)(5), (6), and (7), respectively.

Pursuant to 15 U.S.C. 1640(f), the staff proposes to amend Official Staff Commentary, TIL-1 as follows:

1. The commentary to § 226.4 is amended by removing Comment 4(c)(5)-1, by redesignating Comments 4(c)(6)-1 and 4(c)(7)-1 as Comments 4(c)(5)-1 and 4(c)(6)-1, respectively, and by adding Comment 4(b)(3)-2, to read as follows:

SECTION 226.4 -- Finance Charge

* * * * *

4(b) Examples of Finance Charges

* * * * *

Paragraph 4(b)(3)

* * * * *

2. Seller's points. The points mentioned in § 226.4(b)(3) may include seller's points, that is, charges imposed by the creditor upon the non-creditor seller of property for providing credit to the consumer or for providing credit on certain terms. If seller's points are passed on by the seller to only those consumers using a financing arrangement, then the points are finance charges. Only the amount of the seller's points actually passed on to the consumer is a finance charge. If the creditor is unsure whether the seller's points are being passed on, or unsure of the amount being passed on, the creditor may include in the finance charge the entire amount of the seller's points or any amount in excess of the amount actually passed on.

* * * * *

2. The commentary to § 226.17 is amended by completely revising Comments 17(c)(1)-3 and -5, to read as follows:

SECTION 226.17 -- General Disclosure Requirements

* * * * *

17(c) Basis of Disclosures and Use of Estimates

Paragraph 17(c)(1)

* * * * *

3. Seller buydowns. In certain transactions, a seller may pay an amount, either to the creditor or to the consumer, in order to reduce the consumer's payments or buy down the interest rate for all or a portion of the credit term. For example, a consumer and a bank agree to a mortgage with an interest rate of 15% and level payments over 25 years. By a separate agreement, the seller of the property agrees to subsidize the consumer's payments for the first two years of the mortgage, giving the consumer an effective rate of 12% for that period.

- Whether or not the lower rate is reflected in the credit contract between the consumer and the bank, the disclosures must reflect any portion of the seller's points which is a finance charge. The commentary to § 226.4(b)(3) discusses those seller's points that are disclosed as finance charges.
- If the lower rate is reflected in the credit contract between the consumer and the bank, the disclosures must take the buydown into account. For example, the annual percentage rate must be a composite rate that takes account of both the lower initial rate and the higher subsequent rate, and the payment schedule disclosures must reflect the 2 payment levels.
- If the lower rate is not reflected in the credit contract between the consumer and the bank and the consumer is legally bound to the 15% rate from the outset, the disclosures given by the bank must not reflect the seller buydown in any way. For example, the annual percentage rate and payment schedule would not take into account the reduction in the interest rate and payment level for the first 2 years resulting from the buydown.

* * * * *

5. Split buydowns. In certain transactions, a seller and a consumer both pay an amount to the creditor to reduce the interest rate. The creditor should treat each portion of the buydown based on the discussion of seller and consumer buydown transactions elsewhere in the commentary to § 226.17(c).

* * * * *

(7) Alternative Two--Amendments to the Regulation and Official Staff Commentary. Pursuant to the authority granted in § 105 of the Truth in Lending Act (15 U.S.C. 1604) as amended by Pub. L. 96-221, 94 Stat. 170 (March 31, 1980), the Board proposes to amend Regulation Z (12 CFR Part 226), to read as follows:

1. Section 226.17(a) is amended by revising footnote 38, to read as follows:

SECTION 226.17 -- General Disclosure Requirements

(a) Form of disclosures. ***

38/ The following disclosures may be made together or separately from other required disclosures: the creditor's identity under § 226.18(a), the variable rate example under § 226.18(f)(4), insurance under § 226.18(n), certain security interest charges under § 226.18(o), and seller's points under § 226.18(s).

2. Section 226.18 is amended by adding paragraph (s), to read as follows:

SECTION 226.18 -- Content of Disclosures

* * * * *

(s) Seller's points. If the creditor requires the seller of property or services to pay an amount for providing credit to the consumer or for providing credit on certain terms, the following disclosures:

(1) That the seller has paid an amount to obtain the financing.

(2) The amount that the seller has paid.

(3) That, to the extent the amount is passed on in the form of a higher sales price or other charge to the consumer, the annual percentage rate and other disclosures understate the cost of credit.

3. § 226.24 is amended by redesignating paragraph (b) as paragraphs (b)(1) and (2), by adding paragraph (b)(3), and by adding paragraph (c)(2)(iv), to read as follows:

SECTION 226.24 -- Advertising

* * * * *

(b) Advertisement of rate of finance charge. (1) If an advertisement states a rate of finance charge, it shall state the rate as an "annual percentage rate," using that term. The advertisement shall not state any other rate, except that a simple annual rate or periodic rate that is applied to an unpaid balance may be stated in conjunction with, but not more conspicuously than, the annual percentage rate.

(2) If the annual percentage rate is stated and that rate may be increased after consummation, the advertisement shall state that fact.

(3) If the annual percentage rate is stated and the financing transaction being advertised involves the payment of an amount by the seller to the creditor for providing credit to the consumer or for providing credit on certain terms, the advertisement must state:

(i) That the seller has paid an amount to obtain the financing.

(ii) The amount that the seller has paid.

(iii) That, to the extent the amount is passed on in the form of a higher sales price or other charge to the consumer, the annual percentage rate and other disclosures understate the cost of credit.

(c) ***

(2) ***

(iv) If the financing transaction being advertised involves the payment of an amount by the seller to the creditor for providing credit to the consumer or for providing credit on certain terms:

(A) That the seller has paid an amount to obtain the financing.

(B) The amount that the seller has paid.

(C) That, to the extent the amount is passed on in the form of a higher sales price or other charge to the consumer, the annual percentage rate and other disclosures understate the cost of credit.

* * * * *

4. Appendix H is amended by adding model clause H-16, to read as follows:

APPENDIX H--Closed-End Model Forms and Clauses

* * * * *

H-16--Seller's Points Model Clause

In order to obtain this financing the seller has paid \$ _____.
To the extent this amount has been passed on to you in the form of a higher sales price or other charge, the annual percentage rate and other disclosures given to you understate the cost of your credit.

Pursuant to 15 U.S.C. 1640(f), the staff proposes to amend TIL-1, as follows:

1. The commentary to § 226.4 is amended by revising Comment 4(c)(5)-1, to read as follows:

SECTION 226.4 -- Finance Charge

* * * * *

4(c) Charges Excluded from the Finance Charge

* * * * *

Paragraph 4(c)(5)

1. Seller's points. Section 226.4(c)(5) excludes any charges imposed by the creditor upon the non-creditor seller of property for providing credit to the consumer or for providing credit on certain terms that would otherwise be finance charges. These charges are excluded from the finance charge even if they are passed on to the consumer, for example, in the form of a higher sales price. Seller's points are frequently involved in real estate transactions guaranteed or insured by governmental agencies. A "commitment fee" paid by a non-creditor seller (such as a real estate developer) to the creditor, if not otherwise excluded from the finance charge (see the discussion in Comments 4(a)-1 and -2), should be treated as seller's points. Buyer's points (that is, points charged to the buyer by the creditor), however, are finance charges. Certain disclosures are required in disclosures and advertisements for transactions that involve seller's points; see §§ 226.18(s), 226.24(b)(2), and 226.24(c)(2)(iv) and the accompanying commentary.

* * * * *

2. The commentary to § 226.17 is amended by revising the first bulleted paragraph of comment 17(c)(1)-3 to read as follows:

SECTION 226.17 -- General Disclosure Requirements

* * * * *

17(c) Basis of Disclosures and Use of Estimates

Paragraph 17(c)(1)

* * * * *

3. Third party buydowns. In certain transactions, a seller or other third party may pay an amount, either to the creditor or to the consumer, in order to reduce the consumer's payments or buy down the interest rate for all or a portion of the credit term. For example, a consumer and a bank agree to a mortgage with an interest rate of 15% and level payments over 25 years. By a separate agreement, the seller of the property agrees to subsidize the consumer's payments for the first two years of the mortgage, giving the consumer an effective rate of 12% for that period.

- If the lower rate is reflected in the credit contract between the consumer and the bank, the disclosures must take the buydown into account. For example, the annual percentage rate must be a composite

rate that takes account of both the lower initial rate and the higher subsequent rate, and the payment schedule disclosures must reflect the two payment levels. However, the effects of the amount paid by the seller would not be specifically reflected in the disclosures given by the bank, since that amount constitutes seller's points (see comment 4(c)(5)-1) and thus is not part of the finance charge. Note that a statement is required disclosing the fact that this charge has been paid; the amount of the charge; and the fact that, to the extent the amount has been passed on to the buyer in the form of a higher sales price or other charge, the annual percentage rate and other disclosures understate the cost of credit. See § 226.18(s) and the accompanying commentary.

- o If the lower rate is not reflected in the credit contract between the consumer and the bank and the consumer is legally bound to the 15% rate from the outset, the disclosures given by the bank must not reflect the seller buydown in any way. For example, the annual percentage rate and payment schedule would not take into account the reduction in the interest rate and payment level for the first 2 years resulting from the buydown.

* * * * *

3. The commentary to § 226.18 is amended by adding Comments 18(s)-1 and -2, to read as follows:

SECTION 226.18 -- Content of Disclosures

* * * * *

18(s) Seller's Points.

1. Disclosure required. This section provides that the creditor must inform the consumer of the existence of "seller's points," that is, charges imposed by the creditor on the non-creditor seller of property for providing credit to the buyer or for providing credit on certain terms. This disclosure is not required in transactions involving only commitment fees (charges that are paid in connection with a developer or other seller obtaining financing for a number of sales transactions, are not transaction specific, and do not result in a higher sales price for only customers taking advantage of certain financing).

2. Location and content of disclosure. The disclosure required by § 226.18(s) may be made outside of the so-called "federal box" (that is, separate from the other required disclosures). The disclosure must include all three items of information: that a charge has been paid by the seller in connection with the transaction; the amount of the charge; and that, to the extent the amount has been passed on to the consumer in the form of a higher sales price or other charge, the disclosures do not reflect the full cost of the credit. Appendix H provides a model clause that may be used in making the disclosure. See also §§ 226.24(b)(2) and 226.24(c)(2)(iv) for special rules regarding the advertising of transactions involving seller's points.

* * * * *

4. The commentary to § 226.24 is amended by redesignating the last two sentences of Comment 24(b)-1 as Comment 24(b)(2)-1; by redesignating Comments 24(b)-1, -2, and -3 as Comments 24(b)(1)-1, -2, and -3, respectively; and by adding Comments 24(b)(3)-1 and 24(c)(2)-5, to read as follows:

SECTION 226.24 -- Advertising

* * * * *

24(b) Advertisement of Rate of Finance Charge

Paragraph 24(b)(1)

1. Annual percentage rate. Advertised rates must be stated in terms of an "annual percentage rate," as defined in § 226.22, even though state or local law permits the use of add-on, discount, time-price differential, or other methods of stating rates. Unlike the transactional disclosure of the annual percentage rate under § 226.18(e), the advertised annual percentage rate need not include a descriptive explanation of the term.

* * * * *

Paragraph 24(b)(2)

1. Annual percentage rate subject to change. The advertisement must state that the annual percentage 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 § 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.

Paragraph 24(b)(3)

1. Effect of seller's points. If an annual percentage rate is disclosed in an advertisement and the financing transaction being advertised involves payment of an amount by the seller to the creditor for providing credit to the consumer or for providing credit on certain terms, a disclosure concerning payment of the amount is required. The disclosure must state the fact that such a charge is involved in the transaction; the amount of the charge; and that, to the extent the seller's points have been passed on to the consumer in the form of a higher sales price or other charge, the annual percentage rate understates the cost of credit. In disclosing the amount of the charge, the amount may be that for a typical transaction.

24(c) Advertisement of Terms that Require Additional Disclosures

* * * * *

Paragraph 24(c)(2)

* * * * *

5. Effect of seller's points. If the financing transaction being advertised involves payment of an amount by the seller to the creditor for extending credit to the consumer or extending credit on certain terms, a disclosure concerning the charge is required. The disclosure must state the fact that such a charge is involved in the transaction; the amount of the charge; and that, to the extent the seller's points have been passed on to the consumer in the form of a higher sales price or other charge, the annual percentage rate and other disclosures understate the cost of credit. In disclosing the amount of the charge, the amount may be that for a typical transaction.

* * * * *

5. The commentary to Appendix H is amended by adding Comment H-17, to read as follows:

APPENDIX H--Closed-end Model Forms and Clauses

* * * * *

17. Model H-16. This contains the seller's points disclosure clause.

* * * * *

By Order of the Board of Governors of the Federal Reserve System, July 20, 1982.

(signed) William W. Wiles

William W. Wiles
Secretary of the Board

[SEAL]