FEDERAL RESERVE BANK OF NEW YORK

[Circular No. **9600**
December 15, 1983]

REGULATION Z
Proposed Revision of Official Staff Commentary

To All Depository Institutions, and Others Concerned, in the Second Federal Reserve District:

The Board of Governors of the Federal Reserve System has announced a proposed revision of the official staff commentary on Regulation Z (Truth in Lending). Printed below is an excerpt from the *Federal Register* of December 6, containing the text of the proposed revision.

Comments on the proposal should be submitted by January 31, 1984 and may be directed to our Regulations Division.

ANTHONY M. SOLOMON,
President.

FEDERAL RESERVE SYSTEM

12 CFR Part 226

[Reg. Z; TIL-1]

Truth in Lending; Official Staff Commentary Update

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Proposed official staff interpretation.

SUMMARY: The Board is publishing for comment proposed changes to the official staff commentary to Regulation Z (Truth in Lending), 12 CFR Part 226. The commentary applies and interprets the requirements of Regulation Z with regard to consumer credit transactions and is a substitute for individual staff interpretations of the regulation. The commentary proposals address a variety of questions that have arisen about the regulation, such as the proper treatment of certain mortgage guarantee insurance premiums, certain fees for the use of credit cards in interchange or shared systems, and certain types of variable-rate transactions.

DATE: Comments must be received on or before January 31, 1984.

ADDRESS: Comments should be mailed to William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, Washington, D.C. 20551, or delivered to Room B-2223, 20th and Constitution Avenue, NW., Washington, D.C. between 8:45 a.m. and 5:15 p.m. Comments should include a reference to TIL-1. Comments may be inspected in Room B-1122 between 8:45 a.m. and 5:15 p.m.

FOR FURTHER INFORMATION CONTACT: Contact the following attorneys in the Division of Consumer and Community Affairs, Board of Governors of the Federal Reserve System, Washington, D.C. 20551, at (202) 452-2412 or (202) 452-3867:

Subpart A—Ruth Amberg, Steven Zeisel
Subpart B—Richard Garabedian, Lynn Goldfaden
Subpart C—Clarence Cain, Susan Werthan
Subpart D—Rugenia Silver

SUPPLEMENTARY INFORMATION: (1) *General.* Effective October 13, 1981, an official staff commentary was published to interpret Regulation Z (12 CFR Part 226). The commentary is designed to provide guidance to creditors in applying the regulation to specific transactions. The commentary is updated periodically to address significant questions that arise. There have been two updates to the commentary so far, the first in September 1982 (47 FR 41338) and the second in April 1983 (48 FR 14882). This notice contains the proposed third update. It is expected that it will be adopted in final form in March 1984 with optional compliance until the uniform effective date of October 1 for mandatory compliance.

Certain conventions have been used to highlight the proposed revisions. New language is shown inside bold-faced arrows, while language that would be deleted is set off with brackets.

(2) *Proposed revisions.* Following is a brief description of the proposed revisions to the commentary:

Subpart A—General

Section 226.2—Definitions and Rules of Construction.

2(a)(17) "Creditor".

The last sentence of comment 2(a)(17)(i)-7 would be deleted because it contains a cross-reference to the commentary discussing "arranger of credit," which was deleted in April 1983 (48 FR 14882). The sentence should have been deleted at that time.

Section 226.4—Finance Charge.

4(b) Examples of Finance Charges.

Comment 4(b)(2)–2 would be added to except from the finance charge certain fees imposed on cardholders for the use of electronic terminals in interchange or shared systems. A companion provision would be added to the commentary on § 226.6(b) to retain certain disclosure requirements for these fees.

4(c) Charges Excluded from the Finance Charge.

Paragraph 4(c)(5).

Comment 4(c)(5)–2 would be added to explain the correct treatment of mortgage insurance premiums (and other charges that are normally paid by the borrower) when they are paid at or before settlement in a lump sum by the noncreditor seller. This is most likely to arise in the case of FHA mortgate insurance premiums, which the Department of Housing and Urban Development now collects in a lump sum rather than periodically. If the seller makes the payment, the creditor should treat the amount of the payment as seller's points and exclude it from the finance charge. A creditor who gives disclosures before the payment has been made should rely on the estimate provision of § 226.17(c)(2) to determine the correct disclosures.

Subpart B—Open-End Credit

Section 226.6—Initial Disclosure Statement.

6(a) Finance Charge.

A paragraph would be added to the commentary to § 226.6(a)(2) to clarify the disclosures for discounted variable-rate plans.

6(b) Other Charges.

If the proposal to except certain interchange fees paid by the cardholder from the finance charge is adopted (see proposed comment 4(b)(2)–2), an example would be added to the list of "other charges" in comment 6(b)–1, to clarify that such fees must still be disclosed as "other charges" under §§ 226.6(b) and 226.7(h). In addition to fees assessed by interchange systems, there may be fees assessed by other system participants that should be disclosed to cardholders. An example would be the various fees assessed by terminal owners that are passed through to the cardholder by the card issuer. While card issuers may not know the amounts of the various charges and, therefore, may not be able to disclose them on the initial disclosure statement, such fees may be candidates for disclosure on the periodic statement.

Comment is solicited on the technical aspects of how these terminal fees will be passed through to card issuers—and, subsequently, to cardholders. (For example, some fees may be included in the amount of the transaction and disclosed to the cardholder at the terminal, whereas others may be sent through the system separately from the underlying transaction.) Comment is also solicited on whether there are operational problems in disclosing these fees on the periodic statement.

Section 226.12—Special Credit Card Provisions.

12(b)(3) Notification to Card Issuer.

Comment 12(b)(3)–3 would be added to point out that, under the regulation, the applicability of the liability limitation provision for unauthorized use detailed in § 226.12 is not dependent upon whether the consumer follows the error resolution procedures of § 226.13.

Section 226.13—Billing-Error Resolution.

13(d)(1) Consumer's Right to Withhold Disputed Amount; Collection Action Prohibited.

Language would be added to comment 13(d)(1)–1 to clarify that finance or other charges cannot be imposed on undisputed balances even in subsequent billing cycles, merely because the consumer withholds payment of a disputed amount.

Paragraph 13(g)(1). Comment 13(g)(1)–1 would be revised to make clear that, when the creditor notifies the consumer of amounts still owed from the resolution period, the creditor may not include finance or other charges imposed on the undisputed amounts solely because the consumer withheld payment of a disputed amount.

Section 226.14—Determination of Annual Percentage Rate.

14(a) General Rule.

A comment would be added to the commentary to § 226.14(a) to clarify the circumstances under which creditors may utilize footnote 31a, regarding faulty calculation tools.

Section 226.16—Advertising.

16(b) Advertisement of Terms that Require Additional Disclosures.

Comment 16(b)–4 would be modified to describe several ways of satisfying the required disclosure of the annual percentage rate in an advertisement for a variable-rate plan.

A new comment 16(b)–5 would be added to explain how to advertise discounted variable-rate plans.

Comments 16(b) 5 and 6 would be redesignated as comments 16(b) 6 and 7.

Subpart C—Closed-End Credit

Section 226.17—General Disclosure Requirements.

17(b) Time of Disclosures.

Comment 17(b)–2 would be revised to clarify the time of disclosure when an open-end credit account is converted to a closed-end-transaction. Under some state laws, consummation of the closed-end transaction is deemed to occur at the same time as the opening of the open-end credit plan, even though the conversion may occur several years later. In these cases, the closed-end credit disclosures may be given at the time of the conversion.

Section 226.18—Content of Disclosures.

18(f) Variable Rate.

A paragraph would be added to the commentary to § 226.18(f) to clarify the disclosures for discounted variable-rate transactions.

Section 226.22—Determination of the Annual Percentage Rate.

22(a) Accuracy of the Annual Percentage Rate.

A comment would be added to the commentary to § 226.22(a)(1) to clarify the circumstances under which creditors may utilize footnote 45a, regarding faulty calculation tools.

Section 226.24—Advertising.

24(b) Advertisement of Rate of Finance Charge.

A comment would be added to § 226.24(b) to explain how to advertise discounted variable-rate transactions. The comment would allow creditors to use the advertising rules for buydowns when advertising these transactions.

24(c) Advertisement of Terms That Require Additional Disclosures.

Comment 24(c)(1), relating to the use of downpayments in advertisements, would be revised by the deletion of the second sentence, limiting the application of § 226.24(c)(1) to credit sales. In the staff's view, the removal of this current limitation would better fulfill the purpose of the advertising rules to provide complete information to prospective credit customers.

Subpart D—Miscellaneous

Section 226.28—Effect on State Laws.

28(a) Inconsistent Disclosure Requirements.

The commentary to § 226.28 would be expanded by the addition of two new comments, reflecting recent Board determinations on the effect of the Truth in Lending Act on the consumer credit laws of Mississippi and South Carolina.

List of Subjects in 12 CFR Part 226

Advertising, Banks, banking, Consumer protection, Federal Reserve

System, Finance, Penalties, Truth in lending.

(3) *Text of revisions.* The proposed revisions to the commentary (Supplement I to Part 226) read as follows:

Supplement I—Official Staff Interpretations

Subpart A—General

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Section 226.2—Definitions and Rules of Construction.

2(a) Definitions.

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2(a)(17) "Creditor".

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Paragraph 2(a)(17)(i)

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7. *Trusts.* In the case of credit extended by trusts, each individual trust is considered a separate entity for purposes of applying the criteria. For example:

• A bank is the trustee for three trusts. Trust A makes 15 extensions of consumer credit annually; Trust B makes 10 extensions of consumer credit annually; and Trust C makes 30 extensions of consumer credit annually. Only Trust C is a creditor for purposes of the regulation.

[With regard to the trustee's status, see the commentary to § 226.2(a)(3).]

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Section 226.4—Finance Charge.

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4(b) Examples of Finance Charges.

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Paragraph 4(b)(2).

►2. *Treatment of fees for use of electronic terminals in an interchange or shared system.* Fees paid by the cardholder for use of electronic terminals in an interchange or shared system are not finance charges to the extent that:

• The fee is assessed by someone other than the card issuer (an example of such a fee is a network switch fee);

• The fee for transactions involving access to credit lines is no greater than the fee the cardholder would pay for transactions involving access to asset accounts through the same terminal or on the same interchange; and

• Any fee that is passed through to the cardholder by the card issuer is no greater than the actual fee charged to the card issuer for the transaction.

Note.—However, that certain fees that are excepted from the finance charge under this provision must be disclosed by the card issurer as "other charges" under §§ 226.6(b) and 226.7(h). (See the commentary to § 226.(b).)◄

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4(c) Charges Excluded from the Finance Charge.

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Paragraph 4(c)(5).

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►2. *Other seller-paid amounts.* Mortgage insurance premiums and other charges that are normally paid by the borrower are sometimes paid in a lump sum at consummation or settlement on the borrower's behalf by a noncreditor seller. In such cases, the creditor should treat the payment made by the seller as seller's points, and exclude it from the finance charge.◄

Subpart B—Open-End Credit

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Section 226.6—Initial Disclosure Statement.

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Paragraph 6(a)(2).

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►10. *Discounted variable-rate plans.* In some variable-rate plans, creditors may set an initial rate that is not tied to the index used to make rate adjustments. Typically, this initial rate is lower than the rate would be if it were calculated using the index. When creditors use an initial rate that is not tied to the variable-rate index, the initial disclosure statement should reflect the initial rate (with a statement of how long it will remain in effect), and the current indexed rate together with the other variable-rate information required by footnote 12 to § 226.6(a)(2).◄

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6(b) Other Charges.

1. *General; examples of other charges.* Under § 226.6(b), significant charges related to the plan (that are not finance charges) must also be disclosed. For example:

• Late payment and over-the-credit-limit charges.

• Fees for providing documentary evidence of transactions requested under § 226.13 (billing-error resolution).

• Charges imposed in connection with real estate transactions (See § 226.4(c)(7).)

• Taxes and filing or notary fees excluded from the finance charge under § 226.4(e).

• A tax imposed on the credit transaction by a state or other governmental body, such as a documentary stamp tax on cash advances (See the commentary to § 226.4(a).)

• Membership or participation fees for a package of services that includes an open-end credit feature, unless the fee is required whether or not the open-end credit feature is included. For example, a membership fee to join a credit union would not be an "other charge," even if membership is required to apply for credit.

►• Fees excepted from the finance charge that are assessed by an interchange system and that are paid by cardholders for use of electronic terminals in the interchange system. (See the commentary to § 226.4(b)(2).)◄

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Section 226.12—Special Credit Card Provisions.

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12(b) Liability of Cardholder for Unauthorized Use.

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12(b)(3) Notification to Card Issuer.

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►3. *Relationship to § 226.13.* While unauthorized use may be asserted as a billing error under § 226.13 (a) and (b), limitations on the consumer's liability for unauthorized use do not depend upon following those error resolution procedures. For example, notification of unauthorized use need not be given in writing nor within a specified number of days in order to limit the consumer's liability.◄

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Section 226.13—Billing-Error Resolution.

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13(d)(1) Consumer's Right to Withhold Disputed Amount; Collection Action Prohibited.

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3. *Imposition of additional charges on undisputed amounts.* The consumer's withholding of [the] ►a◄ disputed amount from the total bill cannot subject [the] undisputed [portion] ►balances (including new purchases or cash advances made during the present or subsequent cycles)◄ to the imposition of finance or other charges. For example, if on an account with a free-ride period ►(that is, an account in which paying the new balance in full allows the consumer to avoid the imposition of additional finance charges)◄, a consumer disputes a $2 item out of a total bill of $300 and pays $298 within the free-ride period, the consumer would not lose the free-ride as to [the] ►any◄ undisputed [portion] ►amounts◄, even if the creditor determines later that no billing error occurred. ►Furthermore, finance charges could not be imposed on any new purchases or advances that, absent the unpaid disputed balance, would not have finance charges imposed on them.◄

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13(g) Creditor's Rights and Duties after Resolution.

Paragraph 13(g)(1).

1. *Amounts owed by consumer.* Amounts the consumer still owes may include both minimum periodic payments and related finance and other charges that accrued during the resolution period. ►As noted in the commnetary to § 226.13(d)(1), even if the creditor later determines that no billing error occurred, the creditor may not include finance or other charges that are imposed on undisputed balances solely as a result of a consumer's withholding payment of a disputed amount.◄

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Section 226.14—Determination of Annual Percentage Rate.

14(a) General Rule.

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►5. *Good faith reliance on faulty calculation tool.* Footnote 31a absolves creditors of liability for errors in the annual percentage rate and fiance charge that result from a corresponding error in a calculation tool. The availability of the footnote is limited to faulty calculation tools that are externally produced, not those that were internally prepared by the creditor. Moreover, "good faith" as used in footnote 31a requires some effort on the part of the creditor to independently verify the accuracy of the calculation tool.◄

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Section 226.16—Advertising.

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16(b) Advertisement of Terms That Require Additional Disclosures.

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4. *Variable-rate plans.* ►In disclosing the annual percentage rate in an advertisement for a variable-rate plan, as required by § 226.16(b)(2), the creditor may use an insert showing the current rate; may give the rate as of a specified recent date; or may disclose an estimated rate under § 226.5(c). The requirement in § 226.16(b)(2) to disclose the variable-rate feature may be satisfied by disclosing◄ [An advertisement for a variable-rate plan complies with § 226.16(b)(2) if it discloses] that "the annual percentage rate may vary" or a similar statement, but the advertisement need not include the information required by footnote 12 to § 226.6(a)(2).

►5. *Discounted variable-rate plans—disclosure of the annual percentage rates.* The advertised annual percentage rates for discounted variable-rate plans must include both the initial rate and the current indexed rate, in accordance with comment 6(a)(2)–10.◄

Comments 16(b) 5 and 6 are redesignated 16(b) 6 and 7, respectively.

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Subpart C—Closed-end Credit

Section 226.17—General Disclosure Requirements.

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17(b) Time of Disclosures.

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2. *Converting open-end to closed-end credit.* If an open-end credit account is converted to a closed-end transaction under a written agreement with the consumer, the creditor must provide a set of closed-end credit disclosures before consummation of the closed-end transaction. ►If consummation of the closed-end transaction occurs at the same time as the consumer enters into the open-end agreement, the closed-end credit disclosures may be given at the time of conversion.◄ (See the commentary to § 226.5 regarding conversion of closed-end to open-end credit.)

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Section 226.18—Content of Disclosures.

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18(f) Variable Rate.

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►8. *Discounted variable-rate transactions.* In some variable-rate transactions, creditors may set an initial rate that is not tied to the index used to make rate adjustments. Typically, this initial rate is lower than the rate would be if it were calculated using the index. When creditors use an initial rate that is not tied to the variable-rate index, the disclosures should reflect a composite annual percentage rate based on the initial rate for as long as it remains in effect and the indexed rate at the time of consummation of the transaction for the remainder of the term. For example, in a 30-year transaction with a rate tied to the 6-month Treasury bill rate plus 2 percent, a creditor may set the rate at 9 percent for the first year although the Treasury bill rate at the time of consummation is 10 percent. The disclosures should reflect a composite annual percentage rate based on 9 percent for one year and 12 percent for 29 years. The payment schedule should reflect 12 payments at 9 percent and 348 payments at 12 percent.◄

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Section 226.22—Determination of the Annual Percentage Rate.

22(a) Accuracy of the Annual Percentage Rate.

Paragraph 22(a)(1).

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►5. *Good faith reliance on faulty calculation tool.* Footnote 45a absolves creditors of liability for errors in the annual percentage rate and finance charge that result from a corresponding error in a calculation pool. The availability of the footnote is limited to faulty calculation tools that are externally produced, not those that were internally prepared by the creditor. Moreover, "good faith" as used in footnote 45a requires some effort on the part of the creditor to independently verify the accuracy of the calculation tool.◄

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Section 226.24—Advertising.

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24(b) Advertisement of Rate of Finance Charge.

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►5. *Discounted variable-rate transactions.* The advertised annual percentage rate for discounted variable-rate transactions must be determined in accordance with comment 18(f)–8. To promote the availability of the initial rate reduction in such transactions, creditors or other persons may apply the rules regarding buydowns in comment 24(b)–3 to show the reduced simple interest rate and its effect on the payment schedule without triggering the additional disclosures under § 226.24(c) of the regulation.◄

24(c) Advertisement of Terms That Require Additional Disclosures.

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Paragraph 24(c)(1).

1. *Downpayment.* The dollar amount of a downpayment or a statement of the downpayment as a percentage of the price requires further information. [By virtue of the definition of "downpayment" in § 226.2, this triggering term is limited to credit sale transactions.] It includes such statements as:

- "Only 5 percent down"
- "As low as $100 down"
- "Total move-in costs of $800"

This provision applies only if a downpayment is actually required; statements such as "no downpayment" or "no trade-in required" do not trigger the additional disclosures under this paragraph.

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Subpart D—Miscellaneous

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Section 226.28—Effect on State Laws.

28(a) Inconsistent Disclosure Requirements.

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►11. *Preemption determination—Mississippi.* Effective October 1, 1984, the Board has determined that the following provision in the state law of Mississippi is preempted by the federal law:

- Section 63–19–32(2)(g)—Disclosure of finance charge. This disclosure is preempted in those cases in which the term "finance charge" would be used under state law to describe a different amount than the finance charge disclosed under federal law.

12. *Preemption determination—South Carolina.* Effective October 1, 1984, the Board has determined that the following provision in the state law of South Carolina is preempted by the federal law:

- Section 37–10–102(c)—Disclosure of due-on-sale clause. This provision is preempted, but only to the extent that the creditor is required to include the disclosure with the segregated federal disclosures. If the creditor may comply with the state law by placing the due-on-sale notice apart from the federal disclosures, the state law is not preempted.◄

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Board of Governors of the Federal Reserve System, November 28, 1983.

William W. Wiles,

Secretary of the Board.

[FR Doc. 83–32188 Filed 12–5–83; 8:45 am]

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