

FEDERAL RESERVE BANK
OF NEW YORK

[Circular No. 8664]
October 22, 1979

UNIFORM GUIDELINES FOR ENFORCEMENT OF REGULATION Z
Comment Invited on Proposal to Amend the Guidelines

To All Member Banks, and Others Concerned,
in the Second Federal Reserve District:

The Board of Governors of the Federal Reserve System, in conjunction with the Federal Deposit Insurance Corporation, the Federal Home Loan Bank Board, the National Credit Union Administration, and the Office of the Comptroller of the Currency have invited public comment on a proposal made upon the recommendation of the Federal Financial Institutions Examination Council to revise the Truth in Lending Enforcement Guidelines. The proposal is designed to overcome certain administrative problems and permit the resumption of reimbursements to consumers for overcharges. The following statement was issued by the Board of Governors in this regard:

The Board requested comment by December 21, 1979. The other agencies administering the Guidelines are taking similar actions.

The revisions proposed by the Board were recommended by the Federal Financial Institutions Examination Council, on which the Board is represented by one of its members. The Guidelines were adopted jointly in January by the five Federal bank and thrift institution regulators¹ that also are now represented on the Examination Council. The Council was established this year to make recommendations to its member agencies to promote uniformity in the supervision of financial institutions and to prescribe uniform standards of examination.

In proposing amendments to the Guidelines the Board said:

These recommendations are based upon the agencies' experiences in implementing the Guidelines over the past nine months. Difficulties have been encountered which have resulted in several agencies temporarily suspending the Guidelines on several occasions. The amendments proposed should alleviate the major problems raised by the Guidelines.

In August, the Board authorized temporary suspension of the requirement of the Guidelines for reimbursement of overcharged customers, pending Examination Council review and recommendations. These reimbursements would be reinstated, and reimbursements in general would be resumed under the proposed amendments to the Guidelines.

The proposed amendments to the Guidelines for enforcement of Truth in Lending and its implementing Regulation Z are:

1. Increase the tolerance for minor errors in disclosure of the annual percentage rate to a borrower, from the present $\frac{1}{8}$ of a percentage point to $\frac{1}{4}$ of a point.

In administering the Guidelines the Federal supervisors have found that many believe that the "rounding to the nearest quarter of one percent" permitted by the Guidelines implies an error tolerance of $\frac{1}{4}$ of a point. Further, the use of $\frac{1}{8}$ of a point error tolerance has in many cases created a large administrative burden yielding minimal benefits to consumers.

2. Amend the prescribed period of retroactive application of the Guidelines—including reimbursement—from October 28, 1974 to

a. The date of the previous examination, if violations are found in a current examination (defined as an examination conducted after January 4, 1979, the effective date of the Guidelines).

b. And, where an agency determines that a creditor has persisted in a violation cited in a previous examination, corrective action would be required for all affected loans consummated after the date when the creditor was first notified of the violation.

Depending upon the record of compliance of a creditor, corrective action could be required, under this policy, back to 1969, when the Truth in Lending Act became effective.

At present, the Guidelines call for corrective action on violations on outstanding loans consummated since October 28, 1974, and on terminated loans consummated within two years of the time when the violation was noted.

¹ Federal Reserve Board; Federal Deposit Insurance Corporation; Federal Home Loan Bank Board; National Credit Union Administration and Office of the Comptroller of the Currency.

The agencies have found that use of a single retroactive date raises questions of equal treatment and practicality. The proposed revision seeks to overcome these problems by requiring reimbursement only where lenders persist in violations after being officially warned against them.

3. Add a part of the Guidelines permitting the agencies to use discretion in applying enforcement policy where a violation presents a unique or significant problem.

This amendment would give recognition to the many different types of violations that may arise and, further, to the fact that issues may be involved that have not been foreseen, or that common creditor practices may be encountered that call for a variation in application of enforcement rules.

Such variations would be allowed, under the proposal, only if they are consistent with the purposes of the Guidelines and (in the case of violations involving a common creditor practice) after notification to the Examination Council. Such notification would give all member agencies an opportunity to make similar rulings or to ask for a review of variations that appear to depart significantly from the uniform application of the Guidelines.

The Federal Reserve Board asked, in addition, for comment on the question whether States that have received Board exemption from the Federal Truth in Lending Act (on grounds that the State has a similar statute in force, with adequate measures for enforcement) should be required to adopt enforcement policies substantially similar to the Guidelines, if they are to continue to meet the requirement of having in force adequate enforcement provisions.

Agencies administering the Guidelines have noted that mortgage loans often present lenders with particular difficulties in stating an accurate annual percentage rate (APR) for the loan. In part this is because some of the closing costs typically accompanying a mortgage loan must be included in the APR, while others are not included, and in part it is due to involvement of certain uneven payment schedules.

Consequently the Board asked:

- What aspects of real property transactions create the most serious problems in complying with Regulation Z, and what are the appropriate solutions?
- How useful is the APR to the average borrower in selecting a lender in a real property transaction?
- Would it be equitable—at least temporarily—to limit minimum corrective action in the case of understated APRs, for real property transactions, to inform the borrower of the correct APR and of the civil liability provisions under Section 130 of the Truth in Lending Act?

The Board would welcome comment on any other aspects of the Guidelines, including costs and benefits.

Enclosed—for member banks in this District—is a copy of the complete text of the proposal. It will be published in the *Federal Register*; copies will also be furnished upon request directed to the Circulars Division of this Bank.

Comments on the proposal should be submitted by December 21, and may be sent to our Consumer Affairs and Bank Regulations Department.

THOMAS M. TIMLEN,
First Vice President.

FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL

ON BEHALF OF ITS CONSTITUENT AGENCIES

REGULATION Z

JOINT NOTICE OF STATEMENT OF ENFORCEMENT POLICY

AGENCIES: The Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Home Loan Bank Board, and the National Credit Union Administration.

ACTION: Proposed Amendments to the Statement of Enforcement Policy - Regulation Z.

SUMMARY: The Uniform Guidelines for Enforcement of Regulation Z were adopted, effective January 4, 1979, by the Federal agencies responsible for supervising depository institutions. The agencies believed that Guidelines would promote uniformity in enforcement of the Truth in Lending Act, and that more effective enforcement would be achieved by requiring specific corrective action by financial institutions, including reimbursement to borrowers who had received incorrect disclosures in violation of the Act. After reviewing the application of the Guidelines for nine months, the agencies believe that they are broadly serving the goals for which they were adopted and are significantly increasing awareness among financial institutions of the requirements of the Truth in Lending law. However, certain questions of equity and other problems with the application of the Guidelines have arisen which make amendments desirable. In addition, several questions have been raised on which the agencies desire further information and comment. Recognizing the value of public participation in the promulgation of these Guidelines, the agencies request comments on these proposed changes and questions.

DATES: Comments must be received on or before December 21, 1979.

ADDRESSES: Written comments should be addressed to:

Interagency Enforcement Policy - Regulation Z
c/o Federal Deposit Insurance Corporation
550 Seventeenth Street, N.W.
Washington, D. C. 20429

FOR FURTHER INFORMATION CONTACT: Glenn Loney, Federal Reserve Board, (202) 452-3585; Alan Dombrow, Comptroller of the Currency, (202) 447-1600; Peter M. Kravitz, Federal Deposit Insurance Corporation, (202) 389-4427; John Price, Federal Home Loan Bank Board, (202) 377-6524; and Harry Blaisdell, National Credit Union Administration, (202) 254-8760.

SUPPLEMENTARY INFORMATION: This document sets forth proposed amendments to and questions concerning the Uniform Guidelines for Enforcement of Regulation Z, which were adopted effective January 4, 1979 (44 F.R. 1222). The Guidelines were adopted because coordination among the agencies is

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desirable in order to bring about uniformity in the administrative actions which will be taken when violations of the Truth in Lending Act and Regulation Z are detected.

In issuing the Guidelines, the agencies said, "as new examination data concerning the extent and type of violations are received, the Guidelines will be reviewed and revised as appropriate." The agencies have undertaken a review of the Guidelines because of problems which have arisen with their implementation. During this review period, the agencies are continuing to require full prospective correction of Truth in Lending violations.

The agencies published the corrective action Guidelines in proposal form for public comment on October 18, 1977. More than three hundred comment letters were received and analyzed, and many recommendations were reflected in the final Guidelines published in December, 1978. In general, however, the public comments on the proposed Guidelines did not contain recommendations which, if adopted, would have prevented the problems which have developed since the Enforcement Policy went into effect. The difficulties have surfaced as a result of experience with implementing the policy.

The agencies believe that the problems which have arisen derive primarily from the complexity of the Truth in Lending law and its implementing Regulation Z. The law and regulation went into effect in 1969. Since that time, both the law and the regulation have been amended and expanded. Many staff opinion letters and interpretations have been published, and twelve thousand lawsuits have been brought under the Act.

The agencies strongly support the fundamental disclosure principles of Truth in Lending, and believe that the complexities which have developed result primarily from efforts to apply these broad principles in a highly specific manner to the numerous and complex creditor practices found in the marketplace. The detail and intricacy of the law's current requirements have the effect, in many instances, of confusing rather than assisting the prospective borrower, and of imposing extensive compliance burdens on financial institutions. The agencies strongly believe that statutory simplification of Truth in Lending is now necessary to achieve its purpose of providing borrowers with useful information.

Recent efforts by Congress to enact such simplification have been supported by the agencies, but have not yet been adopted.

In the absence of statutory simplification, the agencies issued corrective action Guidelines which are based on the current law and regulation, and which tend to reflect their continuing difficulties. In light of experience with implementing the Guidelines, the agencies now believe that administrative action is necessary to simplify them and make them more workable.

The agencies' primary concerns revolve around the following areas:

First, the agencies believe that the complexity of the Guidelines has resulted in confusion among creditors, borrowers, and agency examiners regarding their application. Some of the questions which have been raised were addressed through the publication of an interagency Question and Answer Paper on July 5, 1979. However, a large number of new questions and issues continue to arise, which suggests that serious difficulties are still being encountered in implementing the Guidelines.

Part of the reason for the great number of questions about the Guidelines is that they currently permit little agency flexibility and discretion in their interpretation and application. The agencies intentionally limited such discretion, because they believed that intra- and interagency uniformity must be maintained in order to assure equal treatment of all institutions and their customers. While the agencies continue to be committed to the principle of uniformity, experience indicates that greater flexibility is necessary to permit practical implementation of corrective action. Also, the agencies regulate different types of institutions which, to some extent, engage or specialize in different types of lending.

The agencies recognize that a degree of uniformity must be sacrificed in order to permit the flexibility needed for workable implementation of the Guidelines. Nevertheless, the agencies are committed to equal treatment of all parties and intend to use the review period to consider methods of increasing uniformity where it is important and feasible. This commitment to equal treatment of all parties was the reason for the original decision to issue uniform Guidelines.

In addition to recognizing a need for greater flexibility in general implementation, the agencies believe that the current Guidelines are too rigid, specifically in regard to the time period for which retroactive corrective action will be required. The Guidelines currently designate a single date, October 28, 1974, as the start of the period of retroactivity. While the agencies believe the use of this date is valid in principle, they have found that it raises problems in practice. In some instances, the 1974 date appears to impose unduly burdensome requirements on creditors, while in other cases it tends to hinder the appropriate resolution of problems which were in existence prior to 1974. The agencies believe that the Guidelines would operate more effectively if their retroactive application were tailored more precisely to the past performance of the individual institutions.

The agencies are also concerned about the extensive demands which implementation of the Guidelines is placing on their own personnel and resources. Given the current complexity and scope of the program, effective implementation is necessarily drawing resources away from enforcement of other consumer laws and from examination of the institutions for safety and soundness. While the agencies are committed to

requiring corrective action for Truth in Lending violations, they believe that their resources could be allocated more effectively if the Guidelines were narrower in scope and focused more on significant problem areas.

In view of the foregoing considerations, the agencies are proposing three amendments to the Guidelines.

1. Tolerance Limits.

The tolerance permitted for disclosure of the annual percentage rate would be increased from one-eighth to one-quarter of one percentage point. A tolerance margin is provided under the Guidelines in order to recognize the need for a degree of flexibility, as suggested by the provisions contained in 15 U.S.C. 1606 and 12 CFR 226.5 which permit rounding of APR calculations. The tolerance provision avoids discrimination against creditors attempting to disclose the exact APR as a service to their customers, rather than utilizing the method of rounding permitted by the Truth in Lending Act and Regulation Z to disclose less precise rates.

The agencies are proposing to increase the tolerance level because: (a) computing precisely accurate annual percentage rates is difficult for many types of credit transactions, due to the need to account for the multiplicity of finance charges, odd days interest, and other complicating factors; (b) a widespread perception exists among creditors that rounding to the "nearest quarter of 1 percent," 12 CFR 226.5(a), implies an error tolerance of one-quarter of a percentage point; and (c) the agencies believe that the use of a one-eighth percent tolerance frequently produces an administrative burden which is excessive in relation to the corresponding benefit to the customer.

2. Retroactivity.

The time period to which the Guidelines apply would be modified. Corrective action would be required as follows: (1) for violations cited in the current examination, corrective action would be required on loans consummated since the date of the immediately preceding examination; or (2) where the creditor had failed to correct practices or procedures resulting in violations cited in previous examinations, corrective action would be required for loans consummated after the date on which notice of the violation was first given to the creditor. Depending upon the compliance history of the violation, corrective action could be required back to the date of enactment of the Truth in Lending Act.

A "current examination" would be defined as an examination conducted subsequent to January 4, 1979, which was the effective date of the original Guidelines. Revisions in the Guidelines made pursuant to this proposal, however, would also be applied to earlier examinations.

The following table illustrates the periods for which corrective action would be ordered. The dates represent the dates of examinations, with 1979 being the current examination. "V" means that a pattern or practice constituting a given violation was cited in that examination, and "NV" means that the same type of violation was not cited.

In each case, retroactive corrective action would be required from the date of the examination which appears immediately below the horizontal lines shown in the table. This means that corrective action would be ordered on all loans containing the violation which were consummated after that date. No cut-off date is necessary on the corrective action period, because it would automatically terminate at the point at which the institution ceased engaging in the practice which caused the violation.

<u>Examination Date</u>	<u>Representative Situations</u>				
	1	2	3	4	5
1979	V	V	V	NV	NV
1978	NV	V	V	NV	V
1977	NV	NV	V	V	V
1976	NV	NV	NV	NV	NV

In situations 1 and 2, corrective action would be ordered for loans containing the violation which were consummated since the date of the 1978 examination. Note that the date in these two situations is the same, despite the fact that situation 2 involves a repeat violation and situation 1 does not. This is due to the fact that the proposed amendment would distinguish between past examinations and current ones. For past examinations, prior to January 4, 1979, corrective action would be triggered if an institution failed to respond adequately to notification from its supervisory agency that it was engaging in a practice which constituted a Truth in Lending violation. Thus, institutions would be able to avoid the retroactive requirements of the Guidelines if, upon initial notification that they were in violation of the law, they promptly took action to correct the practice prospectively. For current examinations, in contrast, the proposal would require reimbursement for newly-cited violations, on loans consummated since the date of the previous examination.

In situation 3, corrective action would be ordered for loans containing the violation which were consummated since the date of the 1977 examination. In situation 4, no corrective action would be ordered, because the institution corrected the violation upon initial notification. Situation 5 is similar to situation 2; corrective action

would be ordered for loans containing the violation which were consummated since the date of the 1977 examination.

Note that, in determining whether corrective action would apply with respect to past examinations, the key would be whether the same pattern or practice constituting a violation was not corrected by the institution after being cited in the previous examination. Citations for different violations would not be covered for the purposes of retroactive corrective action. However, the agencies maintain the authority, made clear in the current Guidelines, to require corrective action beyond the minimum standard set by the Guidelines in any case where the institution has engaged in a willful or egregious pattern of violations.

The agencies believe that this proposed revision to the Guidelines will result in more equitable treatment of institutions and their customers, and more reasonable administrative costs for implementation and compliance.

3. Flexibility.

A phrase would be added to the Guidelines to make it clear that the agencies retain flexibility to respond appropriately to unique circumstances or significant problems. The amendment would place greater reliance on the judgment and discretion of the agencies to deal with unique situations which raise technical questions concerning the application of the Guidelines. This step toward simplification would avoid the costs and administrative burdens of interagency coordination and action in situations which apply to very few institutions. The amendment also recognizes that the agencies may encounter situations which involve significant issues or common creditor practices which may require varying the implementation of the Guidelines. The proposal would permit such variations if they are consistent with the purposes of the Guidelines, after notification by the agency to the Federal Financial Institutions Examination Council. This notification process is intended to give the other agencies an opportunity to make similar rulings, or to ask for a review of variations which appear to depart significantly from uniform treatment of all institutions.

In addition to these three proposed amendments, the agencies wish to invite comment on any other aspects of the Guidelines which have raised problems or questions. For example, a large portion of the Question and Answer Paper which the agencies issued deals with the application of the Guidelines to credit insurance issues. The agencies would welcome recommendations for improving the Guidelines in these and any other areas.

In addition, there are three specific matters on which the agencies wish to solicit public comment and advice.

1. Cost and Benefit Information.

The agencies believe that additional information on the costs associated with implementation of the Guidelines would be helpful. Two areas are of particular concern.

First, information is requested on the direct and indirect costs associated with implementation of the Guidelines, both for actual reimbursement and for required administrative processes such as locating and identifying loans requiring corrective action, contacting affected customers, and so forth.

Second, comments are requested on ways in which the Guidelines could be amended to reduce administrative burdens on financial institutions, while assuring benefits to customers entitled to corrective action, including reimbursement. Suggestions regarding the standards the agencies should use in evaluating these cost-benefit considerations are also requested.

2. Treatment of Real Estate Loans.

The agencies want to invite comment on the treatment of real estate loans. It has been the experience of the enforcing agencies that long-term real property transactions (e.g., mortgage loans) have presented creditors with particular difficulties in achieving total compliance in the calculation of the Annual Percentage Rate (APR). To some extent, these difficulties result from the requirement that some, but not all of the numerous closing costs associated with the typical mortgage loan are included in the APR calculation. The fact that different rules apply to different types of charges, all of which may be collected together at closing, has often created creditor confusion and resulted in the inadvertent omission of one or more components of the finance charge when computing the APR.

Another prevalent cause for difficulty relates to the various uneven payment schedules encountered with mortgage loan transactions, so-called "irregular transactions." Such uneven schedules most often result from renewal premiums for private or government mortgage guarantee insurance. These renewal premiums, which must be included as part of the finance charge under the regulation, are assessed in a number of ways depending on the insurer. Many common policies compute the premium annually on the declining balance of the loan principal, with one-twelfth of the annual premium collected by the creditor monthly. Because the premium declines each 12-month period, it is necessary to create a loan amortization schedule, derive the anticipated annual renewal premium charge at each anniversary date, and then determine the resultant declining payment schedule. The APR for the payment schedule thus developed may be derived by the Federal Reserve Board's "General Formula" (Supplement I to Regulation Z) or the Federal Reserve Board's APR Tables, Volume II, for irregular transactions. Use of the Volume II table is complex and time consuming. Use of the "General Formula" requires, at the least, a financial function or programmable calculator, and if a significant volume of loans is to be achieved, complete automation of the entire computation process is desirable.

The same general process described above would apply to any mortgage loan transaction that involves unequal disbursements or payments over

the term of the loan. A typical example would be a common construction loan where funds are disbursed as needed at irregular intervals. In such complex situations, creditors have been prone both to computational errors and to attempting mathematical shortcuts which may result in erroneous APR disclosures.

Because the disclosures given in connection with mortgage loans are often correct except for the final computation of the APR, and because of continuing creditor confusion with respect to (a) differentiating between closing costs which are and are not considered prepaid finance charges and (b) the correct method for calculating the APR on "irregular loan transactions," especially where mortgage guarantee insurance or construction financing is involved, the agencies request comment on the three questions set forth below.

First, comment is requested on the particular aspects of real property transactions that create the most serious problems for creditors attempting to comply with Regulation Z. Comment is requested on feasible solutions to these problems, including, but not limited to, such things as the availability of more extensive technical instructions, better education of creditor staffs and changes in lending practices designed to facilitate easier computation of APRs.

Second, the agencies request comment on how important or useful the APR disclosure is to the borrower's actual selection of a lender in real property credit transactions. In particular, comment is requested on whether borrowers normally have already selected a creditor on the basis of other information by the time APR (and other TIL) disclosures are provided prior to consummation of the loan contract. If creditor selection does take place prior to the receipt of Truth in Lending disclosures, the agencies request comment on: (1) what other comparative information and criteria are used in shopping for mortgage credit, and (2) what effect this situation should have on Truth in Lending enforcement procedures, especially with regard to reimbursement for understated APRs.

Third, comment is requested on whether it would be equitable to limit the minimum corrective action required by the Guidelines for understated APRs, in connection with real property transactions, to informing the affected borrowers of their correct APR and of the civil liability provision of Section 130 of the Truth in Lending Act. If such minimum corrective action requirement were adopted by the agencies, comment is requested on: (1) whether this provision should remain effective for only a limited period of time during which creditors would be expected to seek out expert advice and perfect their computational procedures, after which time understated APRs would require reimbursement, and (2) whether such limited minimum corrective action should apply only to "irregular transactions" such as loans having mortgage guarantee insurance or loans for construction financing.

3. Treatment of Exempt States.

The Board of Governors of the Federal Reserve System requests comment on whether states which have received an exemption from the Truth in Lending requirements should be required to adopt enforcement policies substantially similar to the Guidelines in order to maintain their exemption. Currently five states (Maine, Massachusetts, Connecticut, Oklahoma, and Wyoming) have been granted exemptions from most of the Federal Truth in Lending requirements by virtue of their having substantially similar state laws and adequate provisions for enforcing those laws. Thus, state-chartered institutions normally subject to Federal Truth in Lending jurisdiction are instead subject to state jurisdiction. The issue is whether those states, as a condition of maintaining adequate provision for enforcement, and thus their eligibility for exemption, should be required to have provisions for reimbursement similar to those which would be imposed by the Federal agencies if the exemption did not exist.

* * * * *

The following amendments are proposed pursuant to the enforcement authority contained in 15 U.S.C. Section 1607 and 12 U.S.C. Section 1818(b) in the cases of the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency, pursuant to 15 U.S.C. Section 1607 and 12 U.S.C. Sections 1464(d)(2) and 1730(e) in the case of the Federal Home Loan Bank Board, and pursuant to 15 U.S.C. Section 1607 and 12 U.S.C. Section 1786(e)(1) in the case of the National Credit Union Administration.

1. Definitions, Section 3 is amended by substituting "1/4 of 1 percentage point" for "1/8 of 1 percentage point."
2. General Policies, Section 3 is amended deleting the current section and substituting the following:

...Corrective action shall be required for all violations within the scope of these Guidelines (1) cited in the current examination, or (2) cited in an earlier examination or supervisory letter when an agency determines that the creditor failed to correct any such practice by the next succeeding examination. Corrective action under (1) will be required for all loans consummated since the date of the examination immediately preceding the current examination. Corrective action under (2) will be required for all loans consummated after the date of such report or letter in which the practice was first cited. Current examinations shall mean examinations conducted after January 4, 1979.

3. General Policies, Section 1(a) is amended by adding the following at the end of the section:

...nor will it preclude any agency from deviating from the Guidelines (1) with regard to an individual creditor when the agency encounters

unique situations raising technical questions as to the application of the Guidelines, or (2) after notice to the Federal Financial Institutions Examination Council, when the agency encounters situations which involve significant issues or common creditor practices. Any such deviations shall be consistent with the intent of the Guidelines.

Dated: October 15, 1979

(signed) Theodore E. Allison
Theodore E. Allison, Secretary
Board of Governors of the
Federal Reserve System

Dated: October 15, 1979

(signed) J.J. Finn
J.J. Finn, Secretary
Federal Home Loan Bank Board

Dated: October 15, 1979

(signed) Lewis G. Odom, Jr.
Lewis G. Odom, Jr.
Senior Deputy Comptroller
Comptroller of the Currency

Dated: October 15, 1979

(signed) Hoyle L. Robinson
Hoyle L. Robinson
Executive Secretary
Federal Deposit Insurance Corporation

Dated: October 15, 1979

(signed) Rosemary Brady
Rosemary Brady
Secretary to NCUA Board
National Credit Union Administration