FEDERAL RESERVE SYSTEM

12 CFR Part 226

[Regulation Z; Docket No. R-1136]

Truth in Lending

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Proposed rule; official staff commentary.

SUMMARY: This proposal would revise the official staff commentary to Regulation Z, which implements the Truth in Lending Act. The commentary interprets the requirements of Regulation Z. The proposed update would clarify the status of certain credit card-related fees. It also discusses the rules for replacing an accepted credit card with one or more cards; the treatment of private mortgage insurance payments in disclosing the payment schedule; and the selection of Treasury security yields for the purpose of determining whether a mortgage loan is covered by provisions in Regulation Z that implement the Home Ownership and Equity Protection Act.

DATES: Comments must be received on or before January 27, 2003.

ADDRESSES: Comments should refer to Docket No. R-1136 and should be mailed to Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, D.C. 20551, or mailed electronically to regs.comments@federalreserve.gov. Comments addressed to Ms. Johnson may also be delivered, between 8:45 a.m. and 5:15 p.m., to the Board's mail facility in the West Courtyard, located on 21st Street between Constitution Avenue and C Street, N.W. Members of the public may inspect comments in Room MP-500 of the Martin Building between 9:00 a.m. and 5:00 p.m. on weekdays pursuant to § 261.12, except as provided in § 261.14, of the Board's Rules Regarding Availability of Information, 12 CFR 261.12 and 261.14.

FOR FURTHER INFORMATION CONTACT: Krista P. DeLargy or Dan S. Sokolov, Attorneys, or Daniel G. Lonergan, Counsel, Division of Consumer and Community Affairs, Board of Governors of the Federal Reserve System, at (202) 452-3667 or 452-2412; for users of Telecommunications Device for the Deaf ("TDD") only, contact (202) 263-4869.

SUPPLEMENTARY INFORMATION:

I. Background

The purpose of the Truth in Lending Act (TILA), 15 U.S.C. 1601 et seq., is to promote the informed use of consumer credit by providing for disclosures about its terms and cost. The act requires creditors to disclose the cost of credit as a dollar amount (the finance charge) and as an annual percentage rate (APR). Uniformity in creditors' disclosures is intended to assist consumers in comparison shopping for credit. TILA requires additional disclosures for loans secured by consumers' homes and permits consumers to rescind certain transactions that involve their principal dwelling. In addition, the act regulates certain practices of creditors.

TILA is implemented by the Board's Regulation Z (12 CFR part 226). The Board has delegated to officials in the Board's Division of Consumer and Community Affairs authority to issue official staff interpretations of Regulation Z. These interpretations, except in unusual circumstances, are incorporated in the official staff commentary (12 CFR part 226 (Supp. I)), which provides guidance to creditors in applying the regulation to specific transactions. Good faith compliance with the commentary affords creditors protection from liability under section 130(f) of TILA. The commentary is a substitute for individual staff interpretations; it is updated periodically to address significant questions that arise.

Comments on all aspects of the proposed revision to the official staff commentary are invited. It is expected that final revisions to the commentary will be adopted in March 2003. To the extent the revisions impose new requirements on creditors, the effective date for mandatory compliance would be October 1, 2003. See TILA Section 105(d).

II. Proposed Revisions

Subpart B — Open-End Credit

Section 226.6 — Initial Disclosure Statement

6(b) Other Charges

Representatives of the credit card industry have requested official guidance on the status under Regulation Z of two fees charged to consumers in connection with open-end credit plans—a fee imposed when a consumer requests that a particular payment on the credit plan be expedited and a fee imposed when a consumer requests expedited mailing of a credit card. Because the proper characterization of these fees under TILA previously has been unclear, the proposal would revise comment 6(b) to provide guidance on how these fees should be treated for purposes of Regulation Z. For purposes of the proposal, "expedited" refers to any form of payment or delivery other than the standard mail service generally made available to the creditor's customers.

Under Regulation Z, creditors must disclose fees that are "finance charges," which are defined as "charges payable directly or indirectly by the consumer and imposed directly or indirectly by the creditor as an incident to or a condition of the extension of credit." For open-end credit plans, fees that are not finance charges must be disclosed as "other charges" if they are significant fees related to the plan. Regulation Z does not require disclosure of charges that are not considered finance charges or "other charges."

Card issuers increasingly have been making expedited payment services available to consumers. The expedited payment service provides consumers an alternative to mailing a payment that might not reach the card issuer by the due date. To avoid being assessed a late payment fee, the consumer requests expedited payment service for a lesser charge. The service is typically an electronic funds transfer or a draft on the customer's checking account.

A fee charged for expediting a consumer's payment would not appear to be incidental to the extension of credit if this payment method is not established as the regular payment method for the account. Accordingly, the proposal indicates that an expedited payment charge under these circumstances would not be a finance charge.

Comment 6(b)-1 provides examples of "other charges" that must be disclosed to consumers under Regulation Z. The proposal would revise comment 6(b)-1 to indicate that a card issuer's fee for expediting a particular payment should be disclosed as an "other charge" provided that the method of payment was not authorized in advance as the regular payment method for the account. The charge appears to be a significant charge related to the credit plan because the fee is for a service provided in connection with a consumer's payment on the account and because typically the fee is paid to enable the consumer to avoid a late payment fee that is also considered to be an "other charge" for purposes of Regulation Z. Moreover, both expedited payment fees and late payment fees might be imposed on many consumers participating in a credit card plan and, for some consumers, might be regularly occurring charges.

The proposal would also amend comment 6(b)-2, which provides examples of charges that are not "other charges" under Regulation Z, to indicate that a card issuer's fee for expediting delivery of a credit card is not required to be disclosed either as a finance charge or as an "other charge" under the regulation. An expedited delivery fee does not appear to be a finance charge because it would not be incidental to the extension of credit where the card is also available to consumers by standard mail service without paying the fee.

Moreover, the charge would not appear to be an "other charge" under Regulation Z. The service does not appear to be a significant part of the credit plan because the card is also available without paying the fee and because the service is requested by consumers only occasionally, such as when a consumer seeks to replace a lost or stolen credit card and requests expedited mailing.

Staff notes that where a creditor merely passes through a third-party delivery charge, such as an express courier fee, and the creditor does not require the use of the service or retain any portion of the fee, the fee is not a finance charge or "other charge" that must be disclosed under Regulation Z.

Section 226.9 — Subsequent Disclosure Requirements

9(c) Change in Terms

Comment 9(c)(2)-1 would be revised to indicate that a change-in-terms notice is not required when the change involves the fee charged for expediting a consumer's payment. Card issuers generally inform consumers of the amount of the specific charge at the time the consumer agrees to the expedited service. As noted above, consumers typically request the service and pay the expedited payment fee to avoid a late fee. Accordingly, the proposed comment would treat expedited payment fees that are disclosed as "other charges," consistent with the treatment of fees for unanticipated late payment, which also do not require a change-in-terms notice.

Section 226.12 — Special Credit Card Provisions

12(a) Issuance of Credit Cards

Section 132 of TILA, which is implemented by § 226.12(a) of Regulation Z, generally prohibits creditors from issuing credit cards except in response to requests or applications for cards. Section 132 explicitly exempts from this prohibition credit cards issued as renewals of or substitutes for previously accepted credit cards. Existing comment 12(a)(2)-5, the "one-for-one rule," interprets these statutory and regulatory provisions by providing that, in general, a creditor may not issue more than one credit card as a renewal of or substitute for an accepted card (as that term is defined under Regulation Z). The existing staff commentary, however, does not construe Section 132 as requiring one-for-one replacement in all circumstances: existing comment 12(a)(2)-6 provides that an accepted credit/debit card may be replaced by a credit card, and a second card with only debit functions (with or without overdraft capability), since debit cards may be issued on an unsolicited basis under the Electronic Fund Transfer Act and the Board's Regulation E.

Advances in the technology used to send transaction information have allowed card issuers to issue credit cards in different sizes and formats. These changes may generally enhance consumer convenience. A merchant's equipment, however, may determine whether a consumer can use a particular credit card. Certain cards that are reduced in size can be used only if they are swiped through a card reader, while some merchants and automated teller machines use equipment that requires insertion of a "full-size" credit card. Accordingly, some card issuers have requested guidance on the issuance of cards using new technologies, which are intended to supplement but not necessarily replace a cardholder's existing card.

To address these developments, comment 12(a)(2)-6 would be revised consistent with the statute and legislative purpose, to indicate that card issuers may replace an accepted card with more than one renewal or substitute card on the same account where the consumer's total liability for unauthorized use with respect to the account does not increase. In addition, any replacement cards must access only the account of the accepted card and all cards issued under that account must be governed by the same terms and conditions.

Section 132 was one of several credit card provisions added to TILA in 1970, in response to the then-existing practice of mailing unsolicited credit cards to consumers. Proponents of these provisions asserted that unsolicited credit card mailings encouraged some consumers to spend beyond their means, were inconvenient to dispose of, were too easily stolen in the mails, and were a source of anxiety for consumers worried about theft and their own personal liability for unauthorized use. The legislative history also reflects concern about the resulting inconvenience to consumers of refuting unwarranted claims of liability.

Under Section 133 of TILA, consumers have no liability for unauthorized use of a credit card unless they have accepted the card. A credit card issued as a renewal or substitution is not deemed to be accepted until it is received by the cardholder. See 12 C.F.R. § 226.12(a), footnote 21. To avoid monetary losses from the theft of credit cards sent though the mail, card issuers generally send cards that are not activated and employ security procedures requiring the consumer to verify receipt of the card. These industry practices should be as effective when replacing an accepted card with one or more renewal or substitute cards.

The proposed commentary revision is limited to interpreting the provision in Section 132 of TILA that allows an unrequested card to be sent as a renewal of or substitution for an accepted card. Comment is also solicited on whether it would be appropriate to apply this view to additional cards issued for an existing account on the conditions specified in the proposal even when there is no renewal of or substitution for the cardholder's existing card.

Subpart C — Closed-End Credit

Section 226.18 — Content of Disclosures

18(g) Payment Schedule

The disclosures for closed-end loans must include the number, amounts, and timing of payments scheduled to repay the obligation. Premiums paid for insurance that protects the creditor against the consumer's default or other credit loss (sometimes referred to as private mortgage insurance) are finance charges that must be included in the payment schedule. Under the Homeowners Protection Act of 1998, such insurance generally must terminate before the term of the loan expires, and the payment schedule should reflect this fact. Comment 18(g)-5 would be revised to provide additional guidance on how mortgage insurance premiums should be disclosed on the payment schedule when some premiums are collected in advance and escrowed at the time the loan is closed. The proposed comment provides an example to facilitate compliance.

Section 226.19 — Certain Residential Mortgage Transactions

19(b) Certain Variable-Rate Transactions

A technical amendment to comment 19(b)(1)-2 is proposed to change the citation to comment 19(b)-5, as amended (65 FR 17129, March 31, 2000). No substantive change is intended.

Section 226.32 —- Requirements for Certain Closed-End Home Mortgages

32(a) Coverage

Section 226.32 implements the Home Ownership and Equity Protection Act of 1994 (HOEPA), which is part of the Truth in Lending Act. HOEPA requires additional disclosures and provides substantive protections for certain home-secured loans carrying rates or fees above a specified amount. HOEPA's rate-based trigger covers mortgage loans where the annual percentage rate (APR) on the loan exceeds the yield on Treasury securities with a comparable maturity by a specified number of percentage points (8 for first-lien loans, 10 for subordinate-lien loans). For purposes of determining coverage under HOEPA, the loan's APR is compared with the yield on Treasury securities as of the 15th day of the month immediately preceding the month of application. Comment 32(a)(1)(i)-4 would be revised to clarify how creditors should determine the applicable yield on Treasury securities.

Currently, comment 32(a)(1)(i)-4 provides that creditors may use the actual results of Treasury auctions or the Board's "Selected Interest Rates" (statistical release H-15), which is published daily and lists the yield on actively traded issues adjusted to constant maturities. The H-15 is posted on the Board's internet web site at: http://www.federalreserve.gov/releases/h15/update. The comment would be revised to respond to requests for additional guidance on using the H-15. In addition, for the reasons discussed below, the option to use actual auction results would be eliminated.

H-15 constant maturities. The H-15 lists yields for various instruments. Creditors that rely on the H-15 have asked for additional guidance on the appropriate instrument to use when the loan maturity is comparable with more than one instrument. For example, the H-15 lists yields for 6-month Treasury bills as well as for actively traded Treasury securities adjusted to constant maturities of 6 months. To ease compliance and aid in uniformity, the proposed comment would clarify that creditors should use the Treasury constant maturities listed on the H-15.

Loans with 30-year maturities. Creditors relying on the H-15 have requested guidance on which Treasury security is deemed to have a maturity comparable with 30-year mortgage loans. The Department of the Treasury recently ceased auctioning 30-year securities; the H-15 currently lists a long-term average of the yields for Treasury securities with terms to maturity of 25 years and over, and refers to Treasury's formula for estimating a 30-year yield.

The proposed comment would clarify that for purposes of HOEPA's rate-based trigger, creditors should compare the APR on 30-year loans (and other loans longer than 20 years) with the yield for a 20-year constant maturity, and not with the average long-term yield for maturities over 25 years or an estimate for a 30-year yield.

Actual auction results. The proposal would revise comment 32(a)(1)(i)-4 to eliminate the option to use yields of actual auction results. Currently, the longest maturity for auctioned Treasury securities is 10 years, while home-secured loans commonly have terms of 15 years or more. Further, Treasury auctions are held infrequently. The H-15 is updated daily, which affords a more precise determination of the yield for Treasury securities as of the fifteenth day of the month preceding the application, the date mandated by HOEPA. Requiring all creditors to use the H-15 would ensure uniform application of HOEPA by eliminating the possibility that some creditors could use yields from auctions held several months before the loan application, which might differ significantly from the yields updated daily on the H-15. Many creditors already rely on the H-15 rather than actual auction results, and the revision is not expected to significantly affect creditor practices.

Additional Issue

Some financial institutions offer a service to transaction account customers that is commonly referred to as "bounce protection." Institutions apparently provide "bounce protection" in lieu of establishing an overdraft line of credit for the customer. The service varies among institutions and questions have been raised about whether there are circumstances in which the service might be covered by TILA and Regulation Z.

Although the institution generally reserves the right not to pay particular items, under these bounce protection programs, the institution typically establishes a dollar limit for the account holder, and then routinely pays overdrafts on the account up to that amount without a case-by-case assessment. Account holders whose overdrafts are paid pursuant to this service are assessed a fee; in some cases it may be the same amount that would be charged for an overdraft item that is returned unpaid or that is paid by the institution on an ad hoc basis.

In the case of the traditional overdraft line of credit, a financial institution pays an overdraft on a consumer transaction account and extends consumer credit. An institution is not a "creditor" subject to the disclosure requirements of TILA and Regulation Z, however, if the extension of credit is not subject to a finance charge. See § 226.2(a)(17). Under Regulation Z, a finance charge does not include a charge imposed by a financial institution for paying items that overdraw an account unless, as is typically the case for overdraft lines of credit, the payment of such items and the imposition of the charge are previously agreed upon in writing. See § 226.4(c)(3).

Fees imposed in connection with "bounce protection" services may or may not meet the definition of a finance charge. See § 226.4. Information and comment are solicited on how "bounce protection" services are designed and operated and how these services should be treated for purposes of TILA in order to assist the Board in determining whether and how to provide guidance on potential coverage under Regulation Z or to address possible concerns under fair lending or other laws.

III. Form of Comment Letters

Comment letters should refer to Docket No. R-1136 and, when possible, should use a standard typeface with a font size of 10 or 12; this will enable the Board to convert text submitted in paper form to machine-readable form through electronic scanning, and will facilitate automated retrieval of comments for review. Comments may be mailed electronically to regs.comments@federalreserve.gov. If accompanied by an original document in paper form, comments also may be submitted on 3 1/2 inch computer diskettes in any IBM-compatible DOS- or Windows-based format.

IV. Solicitation of Comments Regarding the Use of "Plain Language"

Section 722 of the Gramm-Leach-Bliley Act of 1999 requires the Board to use "plain language" in all proposed and final rules published after January 1, 2000. The Board invites comments on whether the proposed commentary is clearly stated and effectively organized, and how the Board might make the commentary easier to understand.

List of Subjects in 12 CFR Part 226

Consumer protection, Disclosures, Federal Reserve System, Truth in lending.

Text of Proposed Revisions

Certain conventions have been used to highlight the proposed revisions to the text of the staff commentary. New language is shown inside bold-faced arrows while language that would be deleted is set off with bold-faced brackets. Comments are numbered to comply with Federal Register publication rules.

For the reasons set forth in the preamble, the Board proposes to amend 12 CFR part 226 as follows:

PART 226 -- TRUTH IN LENDING (REGULATION Z)

1. The authority citation for part 226 continues to read as follows:

Authority: 12 U.S.C. 3806; 15 U.S.C. 1604 and 1637(c)(5).

2. In Supplement I to Part 226:

a. Under Section 226.6—Initial Disclosure Statement, under 6(b) Other charges, paragraph 1.i. and paragraph 2. are revised.

b. Under Section 226.9—Subsequent Disclosure Requirements, under 9(c)(2) Notice Not Required, paragraph 1. is revised.

c. Under Section 226.12—Special Credit Card Provisions, under Paragraph 12(a)(2), paragraph 6. is revised.

d. Under Section 226.18—Content of Disclosures, under 18(g) Payment schedule, paragraph 5. is revised.

e. Under Section 226.19—Certain Residential Mortgage and Variable-Rate Transactions, under Paragraph 19(b)(1), paragraph 2. is amended by removing "comment 19(b)-4" and adding "comment 19(b)-5" in its place.

f. Under Section 226.32—Requirements for Certain Closed-End Home Mortgages, under Paragraph 32(a)(1)(i), paragraph 4. is revised.

SUPPLEMENT I TO PART 226—OFFICIAL STAFF INTERPRETATIONS
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SUBPART B—OPEN-END CREDIT
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Section 226.6—Initial Disclosure Statement
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6(b) Other charges.

1. General; examples of other charges. * * *

[i. Late payment and over-the-credit-limit charges.**]**
►i. Over-the-credit-limit charges, late payment charges, and charges imposed for expediting a consumer's payment provided that method of payment was not established as the regular payment method for the account.◄
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2. Exclusions. The following are examples of charges that are not "other charges":

i. Fees charged for documentary evidence of transactions for income tax purposes.

ii. Amounts payable by a consumer for collection activity after default; attorney's fees, whether or not automatically imposed; foreclosure costs; post-judgment interest rates imposed by law; and reinstatement or reissuance fees.

iii. Premiums for voluntary credit life or disability insurance, or for property insurance, that are not part of the finance charge.

iv. Application fees under § 226.4(c)(1).

v. A monthly service charge for a checking account with overdraft protection that is applied to all checking accounts, whether or not a credit feature is attached.

vi. Charges for submitting as payment a check that is later returned unpaid (see commentary to § 226.4(c)(2)).

vii. Charges imposed on a cardholder by an institution other than the card issuer for the use of the other institution's ATM in a shared or interchange system. (See also comment 7(b)-2.)

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

►ix. Fees to expedite delivery of a credit card, either at account opening or during the life of the account, when card delivery is also available by standard mail service without paying the fee.◄
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<u>Section 226.9 — Subsequent Disclosure Requirements</u>
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<u>9(c)(2) Notice Not Required</u>

1. <u>Changes not requiring notice.</u> The following are examples of changes that do not require a change-in-terms notice:

i. A change in the consumer's credit limit.

ii. A change in the name of the credit card or credit card plan.

iii. The substitution of one insurer for another.

iv. A termination or suspension of credit privileges.

v. Changes arising merely by operation of law; for example, if the creditor's security interest in a consumer's car automatically extends to the proceeds when the consumer sells the car.

►vi. A change in late payment charges or over-the-limit-charges, or a change in the charge for expediting a consumer's payment provided that method of payment was not established in advance as the regular payment method for the account.◄

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Section 226.12 — Special Credit Card Provisions

12(a) Issuance of credit cards.

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Paragraph 12(a)(2)

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6. One-for-one rule~~—~~exception►s.◄The regulation does not prohibit the card issuer from:

►i.◄ Replacing a debit/credit card with a credit card and another card with only debit functions (or debit functions plus an associated overdraft capability), since the latter card could be issued on an unsolicited basis under Regulation E.

►ii. Replacing an accepted card with more than one renewal or substitute card, provided that: any replacement cards access only the account of the accepted card; all cards issued under that account are governed by the same terms and conditions; and under the account's terms the consumer's total liability for unauthorized use with respect to the account does not increase.◄

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SUBPART C—CLOSED-END CREDIT

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Section 226.18—Content of Disclosures

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18(g) Payment schedule.

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5. Mortgage insurance. The payment schedule should reflect the consumer's mortgage insurance payments until the date on which the creditor must automatically terminate coverage under applicable law, even though the consumer may have a right to request that the insurance be cancelled earlier. ►The payment schedule must reflect the legal obligation. For example, assume that under applicable law, mortgage insurance must terminate after the 130th scheduled monthly payment, and the creditor collects at closing and places in escrow two months of premiums. If the legal obligation provides that the creditor will collect 130 payments and refund the escrowed payments when the insurance is terminated, the payment schedule should reflect 130 premium payments. If the legal obligation provides that the creditor will apply the amount escrowed to the two final insurance payments, the payment schedule should reflect 128 monthly premium

payments.◄ (For assumptions in calculating a payment schedule that includes mortgage insurance that must be automatically terminated, see comments 17(c)(1)-8 and 17(c)(1)-10.)
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SUBPART E—SPECIAL RULES FOR CERTAIN HOME MORTGAGE TRANSACTIONS
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Section 226.32—Requirements for Certain Closed-End Home Mortgages
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32(a) Coverage
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►4. Treasury securities. To determine the yield on comparable Treasury securities for the annual percentage rate test, creditors may use the yield on actively traded issues adjusted to constant maturities published in the Board's "Selected Interest Rates" (statistical release H-15). Creditors must use the yield corresponding to the constant maturity that is closest to the loan's maturity. If the loan's maturity is exactly halfway between security maturities, the annual percentage rate on the loan should be compared with the yield for Treasury securities having the lower yield. For example:

i. If the H-15 contains a yield for Treasury securities with constant maturities of 7 years and 10 years and no maturity in between, the annual percentage rate for an 8-year mortgage loan is compared with the yield of securities having a 7-year maturity, and the annual percentage rate for a 9-year mortgage loan is compared with the yield of securities having a 10-year maturity.

ii. If a mortgage loan has a term of 15 years, and the H-15 contains a yield of 5.21 percent for constant maturities of 10 years, and also contains a yield of 6.33 percent for constant maturities of 20 years, then the creditor compares the annual percentage rate for a 15-year mortgage loan with the yield for constant maturities of 10 years.

iii. If a mortgage loan has a term of 30 years, and the H-15 does not contain a yield for 30-year constant maturities, but contains a yield for 20-year constant maturities, and an average yield for securities with remaining terms to maturity of 25 years and over, then the annual percentage rate on the loan is compared with the yield for 20-year constant maturities.◄

[4. Treasury securities. To determine the yield on a Treasury security for the annual percentage rate test, creditors may use the Board's "Selected Interest Rates" (statistical release H-15) or the actual auction results. Treasury auctions are held at regular intervals for the different types of securities. These figures are published by major financial and metropolitan newspapers and are also available from Federal Reserve Banks. Creditors must use the yield on the security that has the nearest maturity at issuance to the loan's maturity. For example, if a creditor must compare the annual percentage rate to Treasury securities with either 7-year or 10-year maturities, the annual percentage rate for an 8-year loan is compared with securities that have a 7-year maturity; the annual percentage rate for a 9-year loan is compared with securities that have a 10-year maturity. If the loan maturity is exactly halfway between, the annual percentage rate is compared with the Treasury security that has the lower yield. For example, if the loan has a maturity of 20 years and comparable securities have maturities of 10 years with a yield of 6.501 percent and 30 years with a yield of 6.906 percent, the annual percentage rate is compared with 10 percentage points over the yield of 6.501 percent, the lower of the two yields.**]**

By order of the Board of Governors of the Federal Reserve System, acting through the Director of the Division of Consumer and Community Affairs under delegated authority, November 26, 2002.

(signed) Jennifer J. Johnson

Jennifer J. Johnson,
Secretary of the Board.