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FEDERAL RESERVE SYSTEM

12 CFR Part 226

[Regulation Z; Docket No. R-1029]

Truth in Lending

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Proposed rule; official staff interpretation.

SUMMARY: The Board is publishing for comment proposed revisions to the official staff commentary to Regulation Z (Truth in Lending). The commentary applies and interprets the requirements of Regulation Z. The proposed update addresses the prohibition against the issuance of unsolicited credit cards. It provides guidance on calculating payment schedules involving private mortgage insurance. In addition, the proposed update discusses credit sale transactions where downpayments include cash and property used as a trade-in.

DATES: Comments must be received on or before January 22, 1999.

ADDRESSES: Comments, which should refer to Docket No. R-1029, may be mailed to Ms. Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, D.C. 20551. Comments addressed to Ms. Johnson may also be delivered to the Board's mail room between 8:45 a.m. and 5:15 p.m., and to the security control room at all other times. Both the mail room and the security control room are accessible from the courtyard entrance on 20th Street between Constitution Avenue and C Street, N.W. Comments may be inspected in room MP-500 between 9:00 a.m. and 5:00 p.m. in

accordance with ' ' 261.12 and 261.14 of the Board's Rules Regarding the Availability of Information, 12 CFR ' ' 261.12 and 261.14.

FOR FURTHER INFORMATION CONTACT: Jane E. Ahrens, Senior Counsel, or Pamela Morris Blumenthal or James H. Mann, Staff Attorneys; 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, Diane Jenkins at (202) 452-3544.

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. Uniformity in creditors' disclosures is intended to assist consumers in comparison shopping. TILA requires additional disclosures for loans secured by a consumer's home and permits consumers to rescind certain transactions that involve their principal dwelling. In addition, the act regulates certain practices of creditors. The act is implemented by the Board's Regulation Z (12 CFR Part 226).

The Board's official staff commentary (12 CFR Part 226 (Supp. I)) interprets the regulation, and provides guidance to creditors in applying the regulation to specific transactions. The commentary is a substitute for individual staff interpretations; it is updated periodically to address significant questions that arise. The Board expects to adopt revisions to the commentary

in final form in March 1999; to the extent the revisions impose new requirements on creditors, compliance would be optional until October 1, 1999, the effective date for mandatory compliance.

II. Proposed Revisions

Subpart A -- General

Section 226.2 -- Definitions and Rules of Construction

2(a) Definitions

2(a)(15) Credit Card

Section 226.2(a)(15) defines a credit card to include any card or credit device that may be used from time to time to obtain credit. Comment 2(a)(15)-2 provides examples of cards and devices that are and are not credit cards. The comment would be revised to include additional examples of cards or devices that are credit cards, addressing recent programs where cards are marketed from the outset with both credit and non-credit features.

2(a)(18) Downpayment

Comment 2(a)(18)-3 provides guidance on how a creditor discloses the downpayment if a trade-in is involved in a credit sale transaction and if the amount of an existing lien exceeds the value of the trade-in. The comment would be revised to provide additional examples when the downpayment also includes a cash payment.

Subpart B -- Open-end Credit

Section 226.12 -- Special Credit Card Provisions

12(a) Issuance of Credit Cards

12(a)(1)

Section 226.12(a) prohibits creditors from issuing credit cards except in response to a consumer's request or application for the card or as a renewal of, or substitute for, a previously accepted credit card. The prohibition addresses various concerns including the potential for theft and fraud and the consumer inconvenience of refuting claims of liability.

The law does not prohibit creditors from issuing unsolicited cards that have a non-credit purpose--such as check-guarantee or purchase price-discount cards, so long as they cannot be used also to obtain credit. Consumers may later be able to convert these cards to credit cards if the issuer makes a credit feature available and the consumer requests the credit.

Comment 12(a)(1)-7 provides guidance regarding a card that is issued and accepted by the consumer as a non-credit device and that subsequently is converted for use as a credit device at the consumer's request. The comment would be revised to reflect more clearly its intended purpose. For example, a purchase-price discount card may be issued on an unsolicited basis if the card issuer does not propose to connect the card with any credit plan. If the issuer later establishes a credit plan to which the card could be connected and the consumer requests access to the plan, the previously issued card can be re-encoded (or the issuer may reprogram its computers to allow the card to be used to access credit) without violating TILA.

Questions about the comment's meaning have been raised regarding its application to recent programs where unsolicited cards are marketed from the outset as both stored-value cards and credit cards. The revised comment would clarify that, because these multifunction cards are connected with credit plans when they are issued, and thus are credit cards, these cards may not be sent without the consumer's prior request or application. See comment 2(a)(15)-2. To the extent that the interpretation of rule previously may have been unclear, the Board believes that liability should not attach to a card issuer's prior reliance on comment 12(a)(1)-7 in issuing multifunction cards that included a credit feature.

Section 226.14 -- Determination of Annual Percentage Rate

14(c) Annual Percentage Rate for Periodic Statements

Comment 14(c)-10 addresses finance charges that are imposed during the current billing cycle but that relate to account activity that occurred during a prior billing cycle. The comment refers expressly to current-cycle and prior-cycle debits but not to current-cycle or prior-cycle credits. The comment is meant to cover both debits and credits, and would be revised accordingly.

Subpart C -- Closed-end Credit

Section 226.18 -- Content of Disclosures

18(g) Payment Schedule

The Homeowners Protection Act of 1998 (HPA) limits the amount of private mortgage insurance consumers can be required to purchase. Borrowers may request cancellation of private mortgage insurance under some circumstances and lenders must terminate private mortgage

insurance automatically when certain conditions are met. For example, creditors must stop collecting insurance premiums when the outstanding loan balance is 78 percent of the original value of the property provided the account is current (unless the mortgage is "high-risk" as defined in the statute).

Comment 18(g)-5 would be added in response to creditors' requests for guidance on how the requirements of the HPA affect TILA disclosures. TILA disclosures are based on the legal obligation between the parties. (See ' 226.17(c)(1).) The payment schedule disclosure required by section 18(g) should reflect all components of the finance charge, including private mortgage insurance for the time period there is a legal obligation to maintain the insurance.

18(j) Total Sale Price

Comment 18(j)-2 provides the formula for calculating the total sale price in a credit sale transaction. In response to requests for guidance, the comment would be revised to address how the total sale price may be affected by downpayments involving cash and property that is being used as a trade-in and that has a lien exceeding the value of the trade-in.

III. Form of Comment Letters

Comment letters should refer to Docket No. R-1029, and, when possible, should use a standard typeface with a type size of 10 or 12 characters per inch. This will enable the Board to convert the text to machine-readable form through electronic scanning, and will facilitate automated retrieval of comments for review. Also, if accompanied by an original document in paper form, comments may be submitted on 3 1/2 inch computer diskettes in any IBM-compatible DOS- or Windows-based format.

List of Subjects in 12 CFR Part 226

Advertising, Banks, banking, Consumer protection, Credit, Federal Reserve System, Mortgages, Reporting and recordkeeping requirements, 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, under Section 226.2--Definitions and Rules of Construction, the following amendments would be made:

- a. Under Paragraph 2(a)(15) Credit card., paragraph 2. would be revised; and
- b. Under Paragraph 2(a)(18) Downpayment., paragraph 3. would be revised.

The revisions would read as follows:

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SUPPLEMENT I--OFFICIAL STAFF INTERPRETATIONS

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SUBPART A--GENERAL

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Section 226.2--Definitions and Rules of Construction

2(a) Definitions.

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2(a)(15) Credit card.

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2. Examples. i. Examples of credit cards include:

A. A card that guarantees checks or similar instruments, if the asset account is also tied to an overdraft line or if the instrument directly accesses a line of credit.

B. A card that accesses both a credit and an asset account (that is, a debit card).

C. An identification card that permits the consumer to defer payment on a purchase.

D. An identification card indicating loan approval that is presented to a merchant or to a lender, whether or not the consumer signs a separate promissory note for each credit extension.

<E. A card or device that can be activated upon receipt to access credit, notwithstanding the fact that the recipient must first contact the card issuer before using the card.

F. A card that has a substantive use other than credit, such as a purchase-price discount card, if the card also may be used to obtain credit (even if the recipient must first contact the card issuer to access or activate the credit feature).=

ii. In contrast, a credit card does not include, for example:

A. A check-guarantee or debit card with no credit feature or agreement, even if the creditor occasionally honors an inadvertent overdraft.

B. Any card, key, plate, or other device that is used in order to obtain petroleum products for business purposes from a wholesale distribution facility or to gain access to that facility, and that is required to be used without regard to payment terms.

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2(a)(18) Downpayment.

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3. Effect of existing liens. In a credit sale, the Downpayment may only be used to reduce the cash price. For example, when the existing lien on an automobile to be traded in exceeds the value of the automobile, creditors must disclose a zero on the downpayment line rather than a negative number. To illustrate, assume a consumer owes \$10,000 on an existing automobile loan and that the trade-in value of the automobile is only \$8,000, leaving a \$2,000 deficit. The creditor should disclose a downpayment of \$0, not -\$2,000. <Similarly, if the consumer pays \$1,500 in cash (which does not extinguish the \$2,000 deficit) the creditor should disclose a downpayment of \$0, not -\$500. But if the consumer provides \$3,000 in cash (which eliminates the \$2,000 deficit and contributes \$1,000 to reduce the cash price), the creditor should disclose a downpayment of \$1,000.=

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3. In Supplement I to Part 226, under Section 226.12--Special Credit Card Provisions, under Paragraph 12(a)(1), paragraph 7. would be revised to read as follows:

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SUBPART B--OPEN-END CREDIT

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Section 226.12--Special Credit Card Provisions

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12(a) Issuance of credit cards.

Paragraph 12(a)(1)

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7. Issuance of non-credit cards. <i. General. Under 12(a)(1), a credit card cannot be issued except in response to a request or an application. (See comment 2(a)(15)-2 for examples of cards or devices that are and are not credit cards.) A credit feature may be added to a previously issued non-credit card only upon the consumer's specific request. Adding a credit feature includes re-encoding the non-credit device, or reprogramming the issuer's computer program or automated teller machines.

ii. Examples. Purchase-price discount cards may be sent on an unsolicited basis by an issuer that does not propose to connect the card to any credit plan. If the issuer subsequently establishes a credit plan that could be accessed by the card, it may solicit customers who have received the discount cards to offer them the credit feature, and may then reprogram its computers to provide credit access to consumers who request activation of the credit feature.=[The issuance of an unsolicited device that is not, but may become, a credit card, is not prohibited provided:

- C The device has some substantive purpose other than obtaining credit, such as access to non-credit services offered by the issuer;
- C It cannot be used as a credit card when issued; and
- C A credit capability will be added only on the recipient's request.

For example, the card issuer could send a check guarantee card on an unsolicited basis, but could not add a credit feature to that card without the consumer's specific request. The re-encoding of a debit card or other existing card that had no credit privileges when issued would be appropriate after the consumer has specifically requested a card with credit privileges. Similarly, the card issuer may add a credit feature, for example, by reprogramming the issuer's computer program or automated teller machines, or by a similar program adjustment.]

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4. In Supplement I to Part 226, Section 226.14--Determination of Annual Percentage Rate, under Paragraph 14(c) Annual percentage rate for periodic statements., paragraph 10.ii. is republished and paragraph 10.ii.B. would be revised to read as follows:

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Section 226.14--Determination of Annual Percentage Rate

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14(c) Annual percentage rate for periodic statements.

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10. Prior-cycle adjustments.

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ii. Finance charges relating to activity in prior cycles should be reflected on the periodic statement as follows:

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B. If a finance charge <that is posted=[debited] to the account relates to activity for which a finance charge was debited <or credited= to the account in a previous billing cycle, for example, if the finance charge relates to an adjustment such as the resolution of a billing error dispute, or an unintentional posting error, or a payment by check that was later returned unpaid for insufficient funds or other reasons, the creditor shall at its option:

1. Calculate the annual percentage rate in accord with ii.A. of this paragraph, or
2. Disclose the finance charge adjustment on the periodic statement and calculate the annual percentage rate for the current billing cycle without including the finance charge adjustment in the numerator and balances associated with the finance charge adjustment in the denominator.

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5. In Supplement I to Part 226, under Section 226.18--Content of Disclosures, the following amendments would be made:

- a. Under 18(g) Payment schedule., a new paragraph 5. would be added; and
- b. Under 18(j) Total sale price., paragraph 2. would be revised.

The addition and revision would read as follows:

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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.=

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18(j) Total sale price.

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2. Calculation of total sale price. The figure to be disclosed is the sum of the cash price, other charges added under ' 226.18(b)(2), and the finance charge disclosed under ' 226.18(d). <When a credit sale transaction involves property that is being used as a trade-in (an automobile, for example) and that has a lien exceeding the value of the trade-in, the total sale price is affected by the amount of any cash provided. To illustrate, assume a consumer finances the purchase of an automobile with a cash price of \$20,000. The consumer owes \$10,000 on an existing loan on an automobile with a trade-in value of \$8,000, leaving a \$2,000 deficit that the consumer must finance. If the consumer pays \$3,000 in cash and no other costs are financed, the total sale price would be the sum of the \$20,000 cash price and the finance charge; because the \$3,000 cash

payment extinguishes the \$2,000 trade-in deficit no charges are added under ' 226.18(b)(2). (The remaining \$1,000 is a downpayment, which does not affect the total sales price.) However, if the cash payment were \$1,500, the total sale price would be the sum of the \$20,000 cash price, an additional \$500 financed under ' 226.18(b)(2) (the \$2,000 deficit reduced by the \$1,500 cash payment), and the finance charge.=

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By order of the Board of Governors of the Federal Reserve System, acting through the Secretary of the Board under delegated authority, December 1, 1998.

Jennifer J. Johnson,
Secretary of the Board.
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