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July 27, 1989

Ms. Sue Geske
General Manager
Exxon Federal Credit Union
Box 91001
Baton Rouge, LA 70821

Re: Adjustable Rate Mortgage Disclosure (Your
April 5, 1989, Letter)

Dear Ms. Geske:

You have asked us to review your adjustable rate mortgage disclosure form to determine compliance with disclosure requirements of the Truth-in-Lending Act and Regulation Z. The NCUA does not review forms to determine compliance with Regulation Z. You should submit the forms to private counsel for an opinion on compliance with Regulation Z as well as any other applicable laws. We will, however, give general guidance on Regulation Z. The Federal Reserve Board (FRB) is responsible for official interpretation of Regulation Z. We have confirmed our answers to your three questions with the Office of Consumer Affairs at the FRB.

BACKGROUND

Your credit union started offering adjustable rate mortgages (ARM's) in 1983 and indexed these loans to the credit union's cost of funds plus 3 percent. The maturity on all ARM loans was limited to 12 years or less. The index was changed to the three month average of the one-year constant maturity

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Treasury Bill ("T-bill") rate plus 2.5 percent for loans issued after October 1, 1988. Your questions and our answers follow:

1. In view of the 12-year maturity of EFCU ARM loans, is it necessary to give a 15-year history schedule?

Yes. For certain variable-rate transactions, Section 226.19(b)(2) of Regulation Z (12 C.F.R. §226.19(b)(2)) requires creditors to list certain disclosures. Section 226.19(b)(2)(viii) of Regulation Z provides:

An historical example, based on a \$10,000 loan amount, illustrating how payments and the loan balance would have been affected by interest rate changes implemented according to the terms of the loan program. The example shall be based upon index values beginning in 1977 and be updated annually until a 15-year history is shown. Thereafter, the example shall reflect all significant loan program terms, such as negative amortization, interest rate carryover, interest rate discounts, and interest rate and payment limitations, that would have been affected by the index movement during the period.

The FRB has issued Official Staff Comments to this Section of Regulation Z. They are enclosed. Comment 1. explains how to make this disclosure.

Comment 5. explains that a creditor may use one of the three terms or amortizations rates (5, 15, or 30 years) or the actual terms offered by the creditor in the historical example required by Section 226.19(b)(2)(viii). You stated that your FCU offers ARM's varying from 1 to 12-years in maturity. According to Comment 5. ARM loans with terms or amortizations of 10-years or less may use an example based on a 5-year maturity and the interest rate adjustments over the same time period. ARM loans with terms or amortizations from over 10-years to 20-years may use an example based on a 15-year maturity. The disclosure for ARMs with terms or amortizations over 20-years may be based on a 30-year term or amortization. As an alternative, you may base the disclosures on the actual terms or amortizations offered by your institution.

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Comment 5. eases a creditor's disclosure burdens by permitting a creditor to print three different forms which can be used with all variable-rate mortgage transactions regardless of the actual maturity. Prior to the issuance of this comment, a creditor was required to give the historical example using the actual maturity of the loan.

2. As the Index currently in use was effective on all new ARM loans disbursed after October 1, 1988, should the disclosure list history prior to 1988 or as of the effective date (10/1/88)?

Yes. Section 226.19(b)(2)(viii) of Regulation Z requires an example based on a \$10,000 loan amount with a 15-year history as explained in question 1 above. The historical example is to illustrate the affect interest rate swings would have on the loan payments and its balance. The section requires the creditor to disclose a 15-year history to "show how interest rate changes implemented according to the terms of the loan program would have affected payments and the loan balance at the end of each year during a 15-year period." The terms of your present loan program use a T-bill rate as an index. The regulation requires you to give the historical example using the T-bill rate since that is the index used in your present loan program. The regulation requires that you start with the year 1977 and give the historical changes in the T-bill rate until a 15-year history is shown.

3. If the member's statement and/or newsletter mailed with the statement contains a message disclosing the new interest rate to be in effect for the quarter, is it necessary to do a separate mailing to members with ARM loans? Please note that payments on ARM loans do not change during the term of the loan.

Section 226.20(c) of Regulation Z (12 C.F.R. 226.20(c)) provides:

An adjustment to the interest rate with or without a corresponding adjustment to the payment in a variable-rate transaction subject to §226.19(b) is an event requiring new disclosures to the consumer. At least once each year during which an interest rate adjustment is implemented without an accompanying payment change, and at least 25, but no more than 120, calendar days before a payment at a new level is due, the following disclosures, as applicable, must be delivered

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or placed in the mail:

- (1) The current and prior interest rates.
- (2) The index values upon which the current and prior interest rates are based.
- (3) The extent to which the creditor has forgone any increase in the interest rate.
- (4) The contractual effects of the adjustment, including the payment due after the adjustment is made, and a statement of the loan balance.
- (5) The payment, if different from that referred to in paragraph (c)(4) of this section, that would be required to fully amortize the loan at the new interest rate over the remainder of the loan term.

The mailing of your quarterly statements to your members may or may not coincide with the timing requirements of Section 226.20(c). Please consult with your attorney on this issue. The use of your monthly newsletter would probably not meet the notice requirement of this section because of the specific loan information required by Section 226.20(c).

Sincerely,

Hattie M. Ulan

HATTIE M. ULAN
Assistant General Counsel

Enclosure

disclosed, the effect of exercising the option should not be reflected elsewhere in the disclosure, such as in the historical example or in the calculation of the initial and maximum interest rate and payments. [Comp. at § 1941.] [Federal Reserve Board Comment 19(b)(2)(vii)-3, as added effective April 1, 1988, compliance mandatory October 1, 1988, 53 F.R. 11047.]

.40 Comment 19(b)(2)(vii)-4. *Preferred-rate loans.* Section 226.19(b) applies to preferred-rate loans, where the rate will increase upon the occurrence of some event, such as an employee leaving the creditor's employ, whether or not the underlying rate is fixed or variable. In these transactions, the creditor must disclose the event that would allow the creditor to increase the rate such as that the rate may increase if the employee leaves the creditor's employ. The creditor must also disclose the rules relating to termination of the preferred rate, such as that fees may be charged when the rate is changed and how the new rate will be determined. [Comp. at § 1941.] [Federal Reserve Board Comment 19(b)(2)(vii)-4, as added effective April 1, 1988, compliance mandatory October 1, 1988, 53 F.R. 11047.]

.48 Comment 19(b)(2)(viii)-1. *Historical example.* This section requires a creditor to provide an historical example, based on a \$10,000 loan amount originating in 1977, showing how interest rate changes implemented according to the terms of the loan program would have affected payments and the loan balance at the end of each year during a 15-year period. (In all cases, the creditor need only calculate the payments and loan balance for the term of the loan. For example, in a five-year loan, a creditor would show the payments and loan balance for the five-year term, from 1977 to 1981 with a zero loan balance reflected for 1981. For the remaining ten years, 1982-1991, the creditor need only show the remaining index values, margin and interest rate and must continue to reflect all significant loan program terms such as rate limitations affecting them.) Pursuant to this section the creditor must provide a history of index values for the preceding 15 years. Initially, the disclosures would give the index values from 1977 to the present. Each year thereafter the revised program disclosures should include an additional year of index values until 15 years of values are shown. If the values for an index have not been available for 15 years, a creditor need only go back as far as the values are available in giving a history and payment example. In all cases, only one index value per year need be shown. Thus, in transactions where interest rate adjustments are implemented more frequently than once per year, a creditor may assume that the interest rate and payment resulting from the index value chosen will stay in effect for the entire year for purposes of calculating the loan balance as of the end of the year and for reflecting other loan program terms. In cases where interest rate changes are at the creditor's discretion (see the commentary to § 226.19(b)(2)(ii)), the credi-

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tor must provide a history of the rates imposed for the preceding period, beginning with the rates starting in 1977. In giving this history, the creditor need only go back as far as the creditor's rates can reasonably be determined. [Comp. at § 1941.] [Federal Reserve Board Comment 19(b)(2)(viii)-1, as added effective April 1, 1988, 53 F.R. 11047; as amended effective February 28, 1989, compliance mandatory October 1, 1989, 54 F.R. 9417.]

.485 Comment 19(b)(2)(viii)-2. *Selection of index values.* The historical example must reflect the method by which index values are determined under the program. If the creditor uses an average of index values or any other index formula, the history given should reflect those values. The creditor should select one date or, when an average of single values is used as an index, one period and should base the example on index values measured as of that same date or period for each year shown in the history. A date or period at any time during the year may be selected, but the same date or period must be used for each year in the historical example. For example, a creditor could use values for the first business day in July or for the first week ending in July for each of the 15 years shown in the example. [Comp. at § 1941.] [Federal Reserve Board Comment 19(b)(2)(viii)-2, as added effective April 1, 1988, compliance mandatory October 1, 1988, 53 F.R. 11047.]

.49 Comment 19(b)(2)(viii)-3. *Selection of margin.* For purposes of the disclosure required under § 226.19(b)(2)(viii), a creditor may select a margin that has been used during the six months preceding preparation of the disclosures, and should disclose that the margin is one that the creditor has used recently. The margin selected may be used until a creditor revises the disclosure form. [Comp. at § 1941.] [Federal Reserve Board Comment 19(b)(2)(viii)-3, as added effective April 1, 1988, compliance mandatory October 1, 1988, 53 F.R. 11047.]

.50 Comment 19(b)(2)(viii)-4. *Amount of discount or premium.* For purposes of the disclosure required under § 226.19(b)(2)(viii), a creditor may select a discount or premium (amount and term) that has been used during the six months preceding preparation of the disclosures, and should disclose that the discount or premium is one that the creditor has used recently. The discount or premium should be reflected in the historical example for as long as the discount or premium is in effect. A creditor may assume that a discount that would have been in effect for any part of a year was in effect for the full year for purposes of reflecting it in the historical example. For example, a 3-month discount may be treated as being in effect for the entire first year of the example; a 15-month example may be treated as being in effect for the first two years of the example. In illustrating the effect of the discount or premium, creditors should adjust the value of the interest rate in the historical example, and should not adjust the margin or index values. For example, if during the

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six month preceding preparation of the disclosures the fully indexed rate would have been 10% but the first year's rate under the program was 8%, the creditor would discount the first interest rate in the historical example by 2 percentage points. [Comp. at § 1941.] [Federal Reserve Board Comment 19(b)(2)(viii)-4, as added effective April 1, 1988, compliance mandatory October 1, 1988, 53 F.R. 11047.]

In calculating the payments and loan balances disclosed in the historical example, a creditor need not base the disclosures on each term to maturity or payment amortization that it offers. Instead, disclosures for ARMs may be based upon terms to maturity or payment amortizations of 5, 15 and 30 years, as follows: ARMs with terms or amortizations from over 1 year to 10 years may be based on a 5-year term or amortization; ARMs with terms or amortizations from over 10 years to 20 years may be based on a 15-year term or amortization; and ARMs with terms or amortizations over 20 years may be based on a 30-year term or amortization. Thus, disclosures for ARMs offered with any term from over 1 year to 40 years may be based solely on terms of 5, 15 and 30 years. Of course, a creditor may always base the disclosures on the actual terms or amortizations offered. If the creditor bases the disclosures on 5-, 15- or 30-year terms or payment amortization as provided above, the term or payment amortization used in making the disclosures must be stated. [Comp. at § 1941.] [Federal Reserve Board Comment 19(b)(2)(viii)-5, as added effective February 28, 1989, compliance mandatory October 1, 1989, 54 F.R. 9417.]

.515 Comment 19(b)(2)(viii)-6. *Rate caps.* A creditor using the alternative rule described in comment 19(b)(2)(vii)-1 for disclosure of rate limitations must base the historical example upon the highest periodic and overall rate limitations disclosed under section 226.19(b)(2)(vii). In addition, the creditor must state the limitation used in the historical example. (See comment 19(b)(2)(x)-3 for an explanation of the use of the highest rate limitation in other disclosures.) [Comp. at § 1941.] [Federal Reserve Board Comment 19(b)(2)(viii)-6, as added effective February 28, 1989, compliance mandatory October 1, 1989, 54 F.R. 9417.]

.52 Comment 19(b)(2)(viii)-7. *Frequency of adjustments.* In certain transactions, creditors may use the alternative rule described in comment 19(b)(2)(vi)-1 for disclosure of the frequency of rate and payment adjustments. In such cases, the creditor may assume for purposes of the historical example that the first adjustment occurred at the end of the first full year in which the adjustment could occur. For example, in an ARM in which the first adjustment may occur between 6 and 18 months after closing and annually thereafter, the creditor may assume that the first adjustment occurred at the end of the first year in the historical example. (See comment 19(b)(2)(x)-4 for an explanation of

how to compute the maximum interest rate and payment when the initial adjustment period is not known.) [Comp. at § 1941.] [Federal Reserve Board Comment 19(b)(2)(viii)-7, as added effective February 28, 1989, compliance mandatory October 1, 1989, 54 F.R. 9417.]

.53 Comment 19(b)(2)(ix)-1. *Calculation of payments.* A creditor is required to include a statement on the disclosure form that explains how a consumer may calculate his or her actual monthly payments for a loan amount other than \$10,000. The example should be based upon the most recent payment shown in the historical example. However, in transactions in which the latest payment shown in the historical example is not for the latest year of index values shown (such as in a five-year loan), a creditor may provide additional examples based on the initial and maximum payments disclosed under section 226.19(b)(x). The creditor, however, is not required to calculate the consumer's payments. (See the model clauses in H-4(C).) [Comp. at § 1941.] [Federal Reserve Board Comment 19(b)(2)(ix)-1, as added effective February 28, 1989, compliance mandatory October 1, 1989, 54 F.R. 9417.]

.57 Comment 19(b)(2)(x)-1. *Initial and maximum interest rate and payment.* The disclosure form must state the initial and maximum interest rates and payments for a \$10,000 loan originated at the most recent interest rate (index value plus margin) shown in the historical example. In calculating the maximum payments under this paragraph a creditor should assume that the interest rate increases as rapidly as possible under the loan program, and the maximum payment disclosed should reflect the amortization of the loan during this period. Thus, in a loan with 2 percentage point annual (and 5 percentage point overall) interest rate limitations or "caps," the maximum interest rate would be 5 percentage points higher than the most recent rate shown in the historical example. Moreover, the loan would not reach the maximum interest rate increase until the fourth year because of the 2 percentage point annual rate limitations, and the maximum payment disclosed would reflect the amortization of the loan during this period. If the loan program includes a discounted or premium initial interest rate, the most recent rate shown in the historical example should be adjusted by the amount of the discount or premium reflected elsewhere in the disclosure for purposes of the requirements of this paragraph. Furthermore, this disclosure should state the amount by which the most recent rate has been adjusted. (See the commentary to section 226.19(b)(2)(viii) regarding disclosure of the amount of a discount or premium.) The creditor may use an interest rate applicable to the program that is more recent than the latest rate shown in the historical example. [Comp. at § 1941.] [Federal Reserve Board Comment 19(b)(2)(x)-1, as added effective April 1, 1988, compliance mandatory October 1, 1988, 53 F.R. 11047.]

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