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Banks Must Disclose Composite Interest Rate on Discounted Variable Interest Rate Loans

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Recent Cases

Banks Must Disclose Composite Interest Rate on Discounted Variable Interest Rate Loans

In *First National Bank of Council Bluffs, Iowa v. Comptroller of the Currency*, 956 F.2d 1456 (8th Cir. 1992), the Eighth Circuit held that under the Truth in Lending Act ("TILA"), 15 U.S.C. § 1601 (1988 & Supp. I 1989) and Regulation Z of the Federal Reserve Board (the "Board"), 12 C.F.R. § 226 (1987), a lending institution must disclose a composite interest rate to prospective borrowers of discounted variable interest rate loans.

Loans, TILA, and Regulation Z

The First National Bank of Council Bluffs, Iowa ("the Bank") began offering discounted variable interest rate consumer installment loans in 1986, and made a total of 691 such loans between June 1986 and June 1988. For the first year of the loan, the interest rate was well below the Bank's going rate. For the remainder of the loan term, the interest rate assumed the Bank's going rate, which varied from time to time.

TILA and Regulation Z govern the Bank's disclosure requirements for discounted variable interest rate loans. Under TILA, the Board enacted Regulation Z to specify how lending institutions determine the annual percentage rate. Regulation Z enumerates four specific disclosures which the lending institution must make with regard to variable interest rate loans. The Board's official staff commentary ("the Commentary") explains and interprets TILA and Regulation Z. The Commentary states that in making discounted variable interest rate loans, the lending institution should disclose a composite rate based on the discounted rate for the first year and the regular interest rate for the remainder of the loan term.

If a lender fails to follow the Commentary's requirements and makes an inaccurate disclosure to a borrower, TILA authorizes the Comptroller of the Currency ("the Comptroller") to require the lender to reimburse the borrower. However, the Comptroller may only order such reimbursement for disclosure violations made since the date of the "immediately preceding examination."

While the Bank disclosed the discounted rate and the four items specified in Regulation Z on loans the Bank made between June 1986 and June 1988, the Bank did not disclose the composite interest rate required by the Commentary. The Bank explained this lapse by stating that the officials in charge of these loans had not seen the Commentary and were unaware of its requirements.

The Comptroller's staff discovered the Bank's violations in the course of a consumer compliance examination (an examination to determine the Bank's compliance with TILA and Regulation Z) conducted on June 30, 1988. When the Bank refused to correct these violations, the Comptroller instituted administrative proceedings against the Bank. Following an administrative hearing and a decision by an administrative law judge, the Comptroller issued a detailed cease and desist order. The Bank then petitioned the Eighth Circuit Court of Appeals to review the Comptroller's determination. The Eighth Circuit granted the review.

Banks Must Disclose Composite Interest Rates

The Commentary required banks to disclose a composite interest rate for discounted variable interest rate loans. The Bank, however, argued that its failure to disclose the composite interest rate as required by the Commentary did not constitute a violation under TILA or Regulation Z.

Rejecting the Bank's argument, the court held that the Bank's failure to disclose a composite interest rate violated TILA and Regulation Z. The court stated that the Commentary should be consulted when interpreting the requirements of TILA and Regulation Z because the complexity of consumer credit transactions makes it impractical for the Board to explicitly regulate every disclosure issue. Additionally, the court stated that requiring disclosure of a composite rate accomplishes TILA's goal of assuring meaningful disclosure of credit terms. In this way, the court reasoned, the consumer would be better able to compare credit terms and make an informed credit decision.

Bank Errors Resulted from a Pattern or Practice of Violations

TILA directed the Comptroller to require reimbursement of debtors for disclosure errors resulting from a "clear and consistent" pattern or practice of violations. The Bank argued that this language did not apply to its disclosure errors, which resulted from its officers' ignorance of the Commentary's provisions. In contrast, the Comptroller contended that the Bank's errors did result from a pattern or practice of violations because they found that during the time period in question, incorrect disclosures were the rule, not the exception, in the Bank's discounted variable interest rate loans.

The court agreed with the Comptroller, noting that the "pattern or practice" provision of TILA intended to include violations resulting from "faulty procedures or misunderstanding of the act's provisions." Since the Bank's officials' ignorance of the Commentary's requirements caused the disclosure errors, the court concluded that the errors did in fact arise from a "pattern or practice" of violations.

Bank's Violations Were Not Merely Technical and Nonsubstantive

TILA also provided that the Comptroller need not require reimbursement if the Bank's disclosure errors involved only "technical and nonsubstantive" violations that did not adversely affect the information provided to the consumer. Since its disclosure errors resulted from its officers' unfamiliarity with the Commentary and did not mislead or deceive the borrowers, the Bank asserted that TILA did not require the Comptroller to order reimbursement. The court, however, disagreed and held that the Bank's failure to disclose a composite interest rate defeated a central purpose of TILA: to enable borrowers to compare credit terms offered by other lenders.

Reimbursement Only for Loans Made Since "Immediately Preceding" Examination

TILA authorized the Comptroller to order reimbursement from the Bank to borrowers whom the Bank had erroneously disclosed the composite interest rate for loans made since the date of the "immediately preceding examination." The Comptroller conducted an examination of the Bank on December 31, 1987, neglecting to examine the Bank's compliance with TILA and Regulation Z. The Bank contended that TILA only authorized the Comptroller to order reimbursement for loans made since the 1987 examination, the "immediately preceding examination."

In contrast, the Comptroller argued that TILA authorized it to order reimbursement on the basis of loans the Bank had made since June 30, 1985, the date of the last previous examination in which the Comptroller had examined the Bank's compliance with TILA and Regulation Z. Further, the Comptroller contended that the legislative purpose of this portion of TILA required the court to interpret the phrase "immediately preceding examination" to refer to the immediately preceding examination of the same type as the one during which the Comptroller discovered the violations.

The court, however, agreed with the Bank that TILA only authorized the Comptroller to order reimbursement for loans made since the 1987 examination. The court noted that the language of the statute referred only to the immediately preceding examination and did not distinguish between examinations of different types. Since the language of the statute was clear, the court held that it meant exactly what it stated. Consequently, the Comptroller could only order reimbursement on the basis of loans made since the date of the December 31, 1987 examination.

Affirmed in Part; Reversed in Part

The court affirmed the Comptroller's finding that the Bank's failure to disclose a composite interest rate constituted a violation of TILA and Regulation Z. In addition, the court found that the Bank's failure to make such disclosures on almost 700 loans over a two year period constituted a "pattern or practice" of violations. However, the court vacated the Comptroller's order of reimbursement for the period from January 31, 1985 to June 30, 1988 and remanded the case to the Comptroller to consider whether or not to order reimbursement for the discounted variable interest rate loans made from December 31, 1987 to June 30, 1988. ❖

— *Colby M. Green*

Announcement

Fraud Hotline

Consumers who receive telephone calls or postcards telling them they have won prizes can now call a toll-free number to find out if the offer is fraudulent. The National Fraud Information Center, at (800)-876-7060, has been established by a coalition of groups battling telephone fraud. The hotline operates from the National Consumers League from 10 a.m. to 4 p.m. Eastern time.

Insurance Liability Occurs at the Installation of a Potentially Dangerous Product

In ***Eljer Manufacturing, Inc. v. Liberty Mutual Insurance***, 972 F.2d 805 (7th Cir. 1992), the United States Court of Appeals for the Seventh Circuit held that physical injury to tangible property from a defective plumbing system occurred at the installation of the product in a house, not when the product actually malfunctioned and caused physical damage.

Insurance, Plumbing, and Water

Between 1979 and 1986, U.S. Brass, a subsidiary of Eljer Manufacturing Inc., manufactured and sold a plumbing system called "Qest" to plumbing contractors. One-half to three-quarters of a million Qest systems were installed behind walls, below floors, or above ceilings in houses and apartments. Complaints about leaks began within a year after the installation of the first units. Eventually, about 5 percent of the installed systems failed. By 1990, home owners and contractors filed several hundred lawsuits involving almost 17,000 Qest systems.

The suits filed by the contractors and homeowners presented basically two types of claims. The first claim based its recovery on actual system leakage, which caused the home to be water damaged, uninhabitable, or reduced in value. The second claim, based recovery not on actual system leakage, but rather on the homeowner's replacement of the system, which caused deprivation of home usage during the replacement period.

Liberty Mutual Insurance ("Liberty") issued Eljer a series of annual policies between 1979 through 1988. Travelers Insurance provided Eljer excess coverage between 1982 and 1986. These policies covered property damage liability accidentally caused by Eljer or its subsidiaries. Eljer brought this