Proposed Rules

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This section of the FEDERAL REGISTER contains notices to the public of the proposed issuance of rules and regulations. The purpose of these notices is to give interested persons an opportunity to participate in the rule making prior to the adoption of the final rules.

FARM CREDIT ADMINISTRATION

12 CFR Parts 611, 612, 614, and 617

RIN 3052–AC04

Organization; Standards of Conduct and Referral of Known or Suspected Criminal Violations; Loan Policies and Operations; Borrower Rights; Effective Interest Rate Disclosure

AGENCY: Farm Credit Administration (FCA).

ACTION: Proposed rule.

SUMMARY: The FCA (agency, we, or our) proposes to amend its regulations governing disclosure of effective interest rates (EIR) and related information on loans. The proposed rule clarifies the current rule as to when and how qualified lenders must disclose the EIR and other loan information to borrowers; when and how the cost of Farm Credit System (FCS or System) borrower stock must be disclosed to borrowers; and how loan origination charges and other loan information must be disclosed to borrowers. The proposal requires lenders to use a discounted cash flow method in determining the EIR to provide meaningful disclosures to borrowers. However, it does not prescribe detailed calculation procedures. To make the regulations easier to understand and use by borrowers, lenders, and other users, we have rewritten the existing regulations in part 614, subpart K, Disclosure of Loan Information, in a question-and-answer format and moved them to a new part 617.

DATES: Please send your comments to the FCA by March 6, 2003.

ADDRESSES: You may send comments by electronic mail to ''*reg-comm@fca.gov*'' or through the Pending Regulations section of FCA's Web site, ''*http://www.fca.gov.*'' You may also send comments to Thomas G. McKenzie, Director, Regulation and Policy Division, Office of Policy and Analysis, Farm Credit Administration, 1501 Farm Credit Drive, McLean, Virginia 22102–5090 or by facsimile to (703) 734–5784. You may review copies of all comments we receive at our office in McLean, Virginia.

FOR FURTHER INFORMATION CONTACT:

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SUPPLEMENTARY INFORMATION:

I. Objectives

The objectives of our proposal are to:

- Ensure that borrowers receive meaningful and timely disclosure of the EIR and related information on loans;
- Promote consistency in the method used to determine the EIR; and
- Make the regulations easy to understand and use by borrowers, lenders, and other users.

II. Background

Section 4.13(a) of the Farm Credit Act of 1971, as amended (Act), requires the FCA to enact regulations requiring ''qualified lenders'' [1] to provide borrowers, not later than the time of loan closing, with meaningful and timely disclosure of:

- The current rate of interest on the loan;
- The amount and frequency of interest rate adjustments and the factors that the lender may take into account in adjusting rates for adjustable or variable rate loans;
- The effect of any loan origination charges or purchases of stock or participation certificates on the rate of interest on the loan;
- A statement indicating that stock purchased is at risk; and
- A statement indicating the various types of loan options available to borrowers.

The requirements of section 4.13 of the Act are applicable to all loans made by ''qualified lenders'' not subject to the Truth in Lending Act (TILA).[2]

Under section 4.13(a) of the Act, qualified lenders must give borrowers notice of any change in the interest rate applicable to a borrower's loan within a ''reasonable time'' after the change. In addition, section 4.13(b) of the Act requires qualified lenders that offer more than one rate of interest to borrowers to: (1) Provide, upon borrower request, a review of the loan to determine if the proper rate has been established; (2) explain to the borrower, in writing, the basis for the rate charged; and (3) explain to the borrower, in writing, how the credit status of the borrower may be improved to receive a lower interest rate on the loan.

Current FCA regulations implement the disclosure requirements of the Act, but contain limited guidance on several key issues. Additionally, when the statute on EIR disclosure went into effect in the 1980s, borrower stock requirements were generally 5 to 10 percent of the loan amount. Disclosure has varied more in recent years because FCS institutions have established a variety of stockholder capitalization and stock retirement policies. Current System borrower stock purchase requirements range from the minimum (the lesser of 2 percent or $1,000) to various higher amounts. Perhaps more significantly, the capitalization requirements are applied not only on a per loan basis, but also on a per borrower basis. With the multiple stock purchase requirements, new loan programs, and varied methodologies for calculation of effective interest rates, compliance with current EIR disclosure regulations has become more challenging and has led to inconsistent disclosure among qualified lenders.

In August 1998, FCA issued a notice soliciting comments from the public to identify regulations and policies that are ineffective or impose a burden on the System.[3] We received comments requesting that changes be made to our regulations on the EIR disclosure. In a letter to the FCA dated May 17, 2000, the Farm Credit Council (FCC) consolidated input from each Farm Credit district and requested that more changes to our borrower rights regulations be made. We considered all

[1] ''Qualified lenders'' include System lenders (except for a bank for cooperatives) and non-System lenders (other financing institutions (OFIs)) for loans made with funding from a Farm Credit bank. *See* 12 U.S.C. 2202a(a)(6).

[2] 15 U.S.C. 1601 *et seq.* TILA applies to consumer loans and specifically exempts agricultural loans.

[3] *See* 63 FR 44176, August 18, 1998.

comments received on EIR disclosure in developing these proposed amendments and will address changes to other borrower rights regulations in a separate rulemaking.

This proposed rule, however, does not address comments on electronic or Web-based compliance with borrower rights regulations. These issues are subject to FCA's E-commerce rule.[4] System institutions should interpret the terms used in this part broadly to permit electronic transmission, communications, records, and submissions in business, consumer, or commercial transactions, unless otherwise prohibited.

III. Section-by-Section Analysis

To make our regulations easier to understand and use by borrowers, lenders, and other users, we have rewritten the existing regulations in part 614, subpart K, Disclosure of Loan Information, in a question-and-answer format and moved them to a new part 617. The existing part 617, Referral of Known or Suspected Criminal Violations, will be moved to part 612, Standards of Conduct, in a new subpart B, and redesignated as §§ 612.2300 through 612.2303.

In the section-by-section analysis below, we explain our proposed amendments to the current EIR disclosure regulations. We also address comments received pertinent to loan information and EIR disclosures.

Subpart A—General

Section 617.7000—Definitions

Proposed § 617.7000 defines ''effective interest rate'' generally as a measure of the cost of credit that, expressed as an annual percentage rate, shows the effect of borrower stock or participation certificates purchased and loan origination charges on the stated interest rate of a loan. The new definition would replace the current definition of EIR in § 614.4366(b). Proposed § 617.7125 explains how a qualified lender should determine the effective interest rate.

In addition, the proposed amendments reword the definitions of ''adjustable rate loan'' and ''interest rate'' in plain language. We also propose to eliminate the existing definitions of ''fixed rate loan,'' ''loan origination charges,'' and ''standard adjustments factors'' because: (1) The term ''fixed rate loan'' is not used in the proposed rule; (2) the term ''loan origination charges'' is addressed separately in proposed § 617.7115; and (3) a qualified lender would disclose ''the specific factors that the qualified lender may take into account in making adjustments to the interest rate on the loan'' under proposed § 617.7130(b)(5); thus, eliminating the need for these definitions. The two existing definitions for ''loan'' and ''qualified lender'' are reworded slightly but we did not intend to make any substantive change.

Subpart B—Disclosure of Effective Interest Rates

Section 617.7100—Who Must Make and Who Is Entitled To Receive an Effective Interest Rate Disclosure?

Proposed § 617.7100(a) states a basic requirement of section 4.13 of the Act, that a qualified lender is required to provide an effective interest rate disclosure to borrowers for all loans not subject to TILA. Paragraph (a) would replace current § 614.4365.

In its letter requesting regulatory relief, the FCC generally recommended that we amend the current rule to allow a single notice be sent when a borrower has multiple loans that close on the same day. The FCC also suggested that amendments allow a lender to apply a notice given in connection with a loan closing to any future indebtedness by the borrower. The Act requires that an EIR disclosure be made for ''all'' loans. Because each loan is a separate legal obligation and carries its own interest rate and specific terms and conditions, we believe that each loan requires a separate disclosure. However, separate disclosures of multiple loans closed simultaneously may be included in the same notice to the borrower.

Paragraph (b) provides what a lender must do when there is more than one borrower obligated on a loan. Current § 614.4367(d) allows the lender to satisfy the disclosure requirements by providing the disclosure to any one of the primary obligors on the loan. The proposed rule will give borrowers the opportunity to designate, in writing, the person they wish to receive the disclosures. If the borrowers do not designate a particular recipient, the lender must provide the disclosures to at least one borrower primarily liable for repayment of the loan. FCA believes that allowing borrowers, and not just the lender, to designate who will receive the disclosures is more in keeping with the intent of the ''borrower rights'' provisions of the Act and will not be burdensome to the lender.

Section 617.7105—When Must a Qualified Lender Disclose the Effective Interest Rate to a Borrower?

Section 4.13 of the Act requires EIR disclosure not later than the time of loan closing for all covered loans. This rule is easy to apply for new customers, and proposed paragraph (a) contains this general directive for prospective borrowers.

However, the question of when a new EIR disclosure is required to be made to an existing borrower—for example when the borrower ''renews'' or ''refinances'' a loan—has met with varied interpretations under FCA's current regulations. FCC suggests amending the regulatory definition of ''loan'' to include ''any renewal or refinancing of such a loan, but not including any interest rate conversion, reamortization, or other loan servicing action that does not result in a new obligation between a borrower and a qualified lender.'' In general, FCA agrees with the substance of this suggestion. However, rather than change our definition of ''loan'' (which is taken directly from the Act), we instead propose revising the criteria that establish the circumstances in which EIR disclosure is necessary. Paragraph (b), therefore, provides that a qualified lender must make a new EIR disclosure to existing borrowers on or before the date the borrower:

(1) Executes a new promissory note or other comparable evidence of indebtedness;

(2) Purchases additional stock as a condition of obtaining new funds from the qualified lender; or

(3) Pays an additional loan origination charge to the qualified lender as a condition of obtaining new funds.

As the FCC points out, a new note (or other comparable document)—ordinarily executed for a renewal or a refinancing—creates a new, binding legal obligation and therefore must be treated as a new ''loan'' for disclosure purposes. While ''reamortization'' may not require a new disclosure if none of the above conditions is met, any new interest rate on the reamortized loan must be disclosed under the subsequent disclosure requirements of proposed § 617.7135.

Section 4.13(a)(3) of the Act also requires qualified lenders to disclose the effect of ''any'' purchases of stock or participation certificates or loan origination charges. As a result, new disclosure must be made any time a borrower is required to buy stock or pay additional loan origination charges in connection with a lending transaction,

[4] *See* 67 FR 16627, April 8, 2002.

whether under an existing or new promissory note.

Paragraph (b)(2) of proposed § 617.7105 is intended to clarify that no new disclosure is required for additional advances made under an open-end line of credit or similar preexisting arrangement unless one of the three aforementioned conditions occurs. For these types of loans, normally only one EIR disclosure—at the time of loan closing—is required.

Section 617.7110—How Should a Qualified Lender Disclose the Cost of Borrower Stock or Participation Certificates?

The Act and current FCA regulations require a qualified lender to disclose the effect of any purchases of stock or participation certificates on the effective rate of interest on a loan. Where the lender has a per loan stock purchase requirement, this rule is straightforward to apply. However, many System lenders have adopted per member, rather than per loan, stock purchase requirements. This raises the issue of whether previously purchased stock must be included in the EIR for new loans to existing borrowers/stockholders.

Historically, we have advised institutions that stock must be included in the EIR disclosure because stock was generally issued on a per loan basis. After reviewing current stock issuance practices, we have concluded that the Act does not require a qualified lender to include the cost of previously purchased stock in the EIR calculation for new loans. Amounts previously paid to a lender in connection with an earlier, separate loan transaction are not properly included in the EIR calculation as ''interest'' on a subsequent loan because the borrower is not paying that amount to the lender and the lender is not receiving that amount from the borrower in connection with the new ''loan.''

Furthermore, shares of stock in a corporation, such as an FCS lending institution, are personal property, constituting an asset of the owner. Therefore, we believe FCS borrower stock should not be treated as a continuing liability or cost to a borrower. Section 4.13(a)(5) of the Act requires that borrowers be informed that they are purchasing an at-risk equity investment in the System institution. We believe that treating the stock purchase as a continuing cost to the borrower (by continuing to include it in EIR calculations) is at odds with the nature of an at-risk equity investment and confuses the meaning of the section 4.13(a)(5) required disclosure.

We have incorporated this new guidance into the proposed rule by providing that the cost of borrower stock must be included in the EIR calculation only at the time the stock is purchased in connection with a loan transaction, whether purchased with cash, included in a promissory note, or otherwise paid. For subsequent loans made to existing borrowers, only the cost of new stock, if any, purchased in connection with the transaction must be included in the EIR calculation.

Section 617.7115—How Should a Qualified Lender Disclose Loan Origination and Other Charges?

The Act and current FCA regulations require qualified lenders to disclose the effect of ''any loan origination charges'' on the ''effective rate of interest'' on a loan. However, the Act does not define ''loan origination charges,'' and FCA's current regulatory definition (in § 614.4366(f)) does not clearly state which charges should and which should not be included in the EIR calculation. In adopting the current definition of ''loan origination charges,'' FCA looked, in part, to similar terms used in Federal Reserve Board regulations implementing TILA (Regulation Z).

The FCC commented that it did not seem likely that Congress intended System institutions to consider or include in their EIR calculations all or most of the charges listed in Regulation Z and that FCA has not explicitly incorporated Regulation Z's ''Charges excluded from the finance charge'' (12 CFR 226.4(c)). The FCC suggests that since TILA, by its terms, does not apply to agricultural loans, FCA should not look to Regulation Z for guidance in determining what constitutes ''loan origination charges'' under the Act. FCC recommends defining loan origination charges to include ''stock, participation certificates, and fees paid in lieu of interest (points, origination fees, etc.).'' The FCC further states that this would be ''a clearer, more concise, less burdensome definition that would comport with the relevant requirements of the Act, especially in view of the fact that no other lender is required to give an effective interest rate disclosure when it makes an agricultural loan.''

We generally agree with FCC's comments. First, Congress provided, in section 4.13 of the Act, that the EIR disclosure is for loans not subject to TILA. Congress also specifically excluded agricultural loans from TILA requirements because it believed that consumer disclosures were not appropriate.[5] Therefore, while Regulation Z may provide some background guidance, we believe it is not appropriate to graft TILA and Regulation Z definitions or requirements onto Farm Credit Act EIR disclosure requirements.

Second, we agree that only origination fees, points, and similar charges paid to a lender by the borrower should be considered ''interest'' charges and be included in the EIR calculation. However, we also believe that all costs a borrower is required to pay in order to obtain a loan from a qualified lender should be disclosed in some fashion in order to satisfy the intent of section 4.13 of the Act. Therefore, proposed § 617.7115 provides guidance on which loan charges must be included in the EIR calculation and which charges must be disclosed separately.

Paragraph (a) is intended to replace and clarify the current definition of ''loan origination charges'' found in § 614.4366(f). It requires that any one-time charge paid by a borrower to a qualified lender in consideration for making a loan be included in the EIR calculation as a loan origination charge. Loan origination charges include, but are not limited to, loan origination fees, application fees, and conversion fees charged by the lender. Loan origination charges also include any payments made by a borrower to a qualified lender to reduce the interest rate that would otherwise be charged, including any charges designated as ''points.''

Ordinarily, any general administrative or processing fee charged by a lender to recover the lender's operating costs constitutes added lending costs to borrowers that must be included in the loan origination charges under paragraph (a). However, loan origination charges should not include any general fee collected by a lender on behalf of third parties or other fees charged by the lender for specific services rendered to borrowers.

We added paragraph (b) to provide that all other payments that a borrower is required to make to obtain a loan, but not included in the loan origination charges described in paragraph (a) in the EIR calculation, must be disclosed separately at the time of loan closing. These include, but are not limited to, real or personal property taxes, guarantee fees, or insurance premiums paid by borrowers to third parties, and appraisal fees paid either to the lender or to a third party.

We believe only charges that could reasonably be defined as ''interest''

[5] *See* S. Rep. 96–338, at 24 (1980), reprinted in 1980 U.S.C.C.A.N. 259

received by the lender in exchange for making the loan should be included in the EIR calculation. Having fewer items included in the EIR more clearly demonstrates the effect of stock and origination charges paid to the qualified lender and reduces artificial inflation of the EIR. We also believe that separate disclosure of charges not included in the EIR calculation, consisting of a list of the actual cost of other items, is more meaningful to borrowers than including them in the EIR calculation.

Section 617.7120—How Should a Qualified Lender Present the Disclosures to a Borrower?

Paragraph (a) requires a qualified lender to disclose the effective interest rate and other required information clearly and conspicuously in writing, in a form that is easy to read and understand and that may be kept by the borrower. Paragraph (b) further provides that the required disclosures cannot be combined with any information not directly related to the information required by proposed §§ 617.7130 and 617.7135. These standards are intended to provide reasonable assurance that qualified lenders provide user-friendly, meaningful disclosures to borrowers. We also propose to eliminate the model forms contained in the Appendix to 12 CFR 614.4367 of the current regulations to permit lenders to tailor their disclosures to a variety of loan types.

Section 617.7125—How Should a Qualified Lender Determine the Effective Interest Rate?

Current FCA regulations provide direction as to the general requirements of EIR disclosures; they do not, however, prescribe a specific formula or methodology for calculation of an effective interest rate. The absence of a definitive methodology for calculating an effective interest rate has led to the use of different approaches—ranging from simplistic to a more complex discounted cash flow method.

Proposed § 617.7125 provides that a qualified lender must calculate the effective interest rate on a loan using a discounted cash flow method showing the effect of the time value of money in determining the EIR. Further, the proposed rule provides that, for all loans, the cash flow stream used for calculating the effective interest rate of a loan must include: (1) Principal and interest; (2) the cost of stock or participation certificates that a borrower is required to purchase in connection with the loan; and (3) loan origination charges described in § 617.7115(a).

The discounted cash flow method required by proposed § 617.7125 is conceptually similar to the formula prescribed in Regulation Z for determination of the annual percentage rate (APR) on loans subject to TILA. While loan charge components differ between the EIR required by the Act and the APR required by Regulation Z, we believe requiring the disclosure of an EIR determined under a widely used method for analyzing the cost of credit would provide more meaningful information to borrowers.

As discussed earlier, we believe it is not appropriate to graft TILA or Regulation Z requirements onto the Act's EIR disclosure requirements. Consequently, the proposed rule does not impose, on qualified lenders, a formula or specific procedures for calculating the EIR. Instead, we propose that all qualified lenders establish policies and procedures for calculating the EIR and use a standard methodology (the discounted cash flow method) for determining required EIR disclosures to borrowers.

Paragraph (c) requires lenders to establish policies and procedures for disclosing the effect of the cost of borrower stock and loan origination charges on the interest rate of a loan. Qualified lenders will also be required to establish policies and procedures for determining the major assumptions used in calculating the EIR, such as for calculating the EIR for adjustable rate loans, revolving or open-end lines of credit, or other loans where key terms may vary or may not be fixed. Qualified lenders may not, however, assume retirement of stock in calculating the EIR disclosed to borrowers because the Act provides that borrower stock is ''at risk'' and a qualified lender cannot guarantee stock retirement. Qualified lenders, may, however, provide supplemental disclosures to borrowers to demonstrate the effect of potential stock retirements so long as the additional disclosures are not misleading.

In considering the best way to achieve consistent, accurate, and meaningful EIR disclosures, the FCA considered common practices in the financial services industry for similar disclosures. Regulation Z for consumer credit provides detailed requirements for uniform APR calculations that essentially use a discounted cash flow method. Because the discounted cash flow method for calculating an EIR explicitly and routinely weighs the time value of money, we believe it produces the most accurate reflection of a loan's cost.

Although the discounted cash flow method involves somewhat complex mathematical computations, the FCA does not believe a requirement to use this method would cause undue burden to lenders. A survey of System-lender disclosures we conducted in the spring of 2002 indicated that a substantial majority (more than 80 percent) of FCS lenders have already incorporated discounted cash flows in their EIR calculations. In addition, a variety of computer-based tools for calculating effective interest rates are readily available in the market place at a reasonable cost.

FCA believes that the complexity of agricultural lending requires a more flexible disclosure approach than provided for under Regulation Z. Therefore, rather than prescribing the exact form and content of disclosure, the proposed rule requires qualified lenders to disclose the EIR and other loan information to borrowers in a form that is easy to read and understand and that the borrower may keep, as long as disclosures are made clearly and conspicuously in writing. However, as discussed above, qualified lenders must establish written policies and procedures regarding disclosure of the EIR and loan information to borrowers and apply the policies and procedures consistently. Each qualified lender must also maintain adequate documentation showing how the lender calculated and disclosed the EIR on each loan.

When a single borrower closes on multiple loans simultaneously and the borrower is required to purchase stock and pay loan origination charges on a per borrower basis, a qualified lender must retain documentation evidencing specific procedures used for assigning costs among the loans in determining the EIR for each particular loan.

To illustrate the determination of an EIR based on discounted cash flows, we have included two examples in Part IV of this preamble.

Section 617.7130—What Initial Disclosures Must a Qualified Lender Make to a Borrower?

(a) *Required disclosures-in general*—To ensure that all essential elements of a loan are disclosed, the information required by existing § 614.4367(a)(1), (3), (4), and (5) are incorporated in proposed § 617.7130(a). Qualified lenders must disclose the following in writing:

(1) The interest rate on the loan;

(2) The effective interest rate of the loan;

(3) The amount of stock or participation certificates that a borrower is required to purchase in connection with the loan and included in the calculation of the effective interest rate of the loan;

(4) All loan origination charges included in the effective interest rate;

(5) All other charges not included as loan origination charges in the effective interest rate calculation that borrowers are required to pay to obtain a loan;

(6) That stock or participation certificates that borrowers are required to purchase are at risk and may only be retired at the discretion of the board of the institution; and

(7) The various types of loan options available to borrowers, with an explanation of the terms and borrower rights that apply to each type of loan.

The information required above is intended to reflect the actual loan for which the disclosure is being provided. The qualified lender may, at its discretion, include additional disclosures or examples—including illustrations of the impact on the effective interest rate of any change in borrower stock ownership—so long as such disclosures are not misleading.

The FCC contended in its comment letter that existing § 614.4367(a)(3), which requires the computation of EIR to be made on a transaction-specific basis, goes beyond the requirement of section 4.13(a)(3) of the Act. The FCC believes that the statutory requirement could be satisfied by using a representative example based on a generic transaction and recommended that FCA allow disclosure through the use of a standard example.

As indicated in prior rulemakings, we disagree with this approach and believe that in order for borrower disclosure to be ''meaningful,'' as is required by statute, the disclosure should take into account the specific loan for which the disclosure is being provided. The EIR disclosed should be derived from the interest rate and related charges applicable to the loan being made to the borrower. However, for adjustable or revolving loans where the terms and conditions are not fixed or are subject to change, a disclosure of the EIR based on the terms and conditions known at the inception of the loan, coupled with representative examples showing the effect of changes in any of the cost elements of the loan, *e.g.*, borrower stock, loan origination charges, or interest rate, on the EIR would be appropriate under the circumstances.

(b) *Adjustable rate loans*—Information required by current § 614.4367(a)(2) is incorporated in proposed § 617.7130. Qualified lenders must disclose to borrowers at the inception of adjustable rate loans:

(1) The circumstances under which the rate can be adjusted;

(2) How much the rate can be adjusted at any one time and how much the rate can be adjusted during the term of the loan;

(3) How often the rate can be adjusted;

(4) Any limitations on the amount or frequency of adjustments; and

(5) The specific factors that the qualified lender may take into account in making adjustments to the interest rate on the loan.

Paragraph (b)(5) was added to replace the current definition of ''standard adjustments factors'' in § 614.4366(h), which includes those factors typically taken into consideration by a qualified lender in adjusting the interest rate on loans, such as a lender's cost of funds, operating expenses, provision for loan losses, changes in retained earnings, etc.

Section 617.7135—What Subsequent Disclosures Must a Qualified Lender Make to a Borrower?

(a) *Notice of interest rate change*—Section 4.13(a)(4) of the Act requires qualified lenders to provide notice to borrowers of ''any change in the interest rate applicable to the borrower's loan'' within a ''reasonable time after'' the effective date of increase or decrease. Current § 614.4367(b)(3) requires notice to be made within 10 days after the effective date of the rate change. For loans with interest rates directly tied to a widely publicized external index, the notice may be made within 30 days after the effective date of the rate change.

The FCC recommends that the period in which disclosure must be made should be the same for all loans, regardless of any tie to an external index, in order to ''simplify the disclosure process for System institutions.'' However, under the current regulation, a System lender may choose to make disclosure for all adjustable rate loans within 10 days of the effective date of a change. Therefore, no regulatory change is necessary to achieve this recommendation. Additionally, when we adopted the 10- and 30-day rule in 1996, we said that the ''need to provide timely information to borrowers outweighed the regulatory burden that a 10-day post-notice may entail.'' We continue to believe that a longer notice period is not appropriate for ''administered rate loans'' (adjustable rate loans not tied to a widely published external index), thus we retain the 10-day requirement in the proposed rule at § 617.7135(a)(3).

The FCC also recommends that ''where an interest rate is based on a widely publicized external index plus a spread, disclosure of a change of rate should not be required merely when the index changes but should be required only when the change in rate is caused by a change in the spread.'' In support, FCC notes that: (1) Borrowers receive notice in their original contract of what the index is and when the rate can change; (2) borrowers can easily find changes in the index through readily available sources; (3) anticipated changes in an external index (as opposed to unanticipated changes in the spread) would not have much impact on a borrower's decision to refinance with another lender; and (4) when an external index changes, there is no change to the borrower's contract rate of interest (index plus spread).

However, we believe eliminating the notice of interest changes for index rate loans is not appropriate. The Act requires notice of ''any change in the interest rate applicable to the borrower's loan.'' While the contract rate (index plus spread) may not have changed, it is clear that when the index changes, the rate of interest the borrower pays on the loan has changed. There is nothing in the legislative history of the Act to suggest that Congress intended to exempt index rate loans from the disclosure requirement. Furthermore, we believe it is important to remind borrowers that interest rate changes will affect their payment amounts.

We propose to extend the deadline to provide notice on loans directly tied to a widely publicized index from 30 to 45 days. This would allow lenders that provide monthly billing or account statements sufficient time to include the notice of change with the regular mailing. The notice could also be satisfied by providing the required disclosure to borrowers in any form of correspondence, such as a newsletter.

We considered revising the rule to allow qualified lenders to send notice with the borrower's next regularly scheduled billing or account statement. However, for annual, semiannual, or quarterly payment loans, it could result in some borrowers not receiving notice of interest rate change for a considerable time period. We did not believe that would constitute ''reasonable'' notice for those borrowers and would result in significantly disparate treatment for borrowers depending on their payment schedule.

We consider the nationally published commercial bank Prime Rate and the London Interbank Offered Rate (LIBOR) to be the primary examples of widely publicized external indexes. Other rates may also qualify, but the qualified lender must ensure that the rate is published in a source readily available to its borrowers. The 45-day rule applies only for changes in the index itself; if the lender changes the spread, a 10-day post-notice is required.

We do not propose to materially alter the required content of the notice. Current and proposed rules require notice of the new interest rate and the effective date of the new rate. In the only change, we eliminated the reference to ''standard adjustments factors'' and now propose that lenders directly disclose ''the factors used to adjust the interest rate on the loan,'' *e.g.*, spread, index averages, etc., in the notice.

(b) *Notice of increase in stock purchase requirement*—Current § 614.4367(c) requires that each qualified lender ''that takes any action which changes the amount of stock or participation certificates which borrowers are required to own and that modifies the effective interest rate'' send a notice to borrowers at least 10 days before the effective date of the action. The FCC recommends that the 10-day prior notice be changed to a 30-day post-notice, stating that when there is a stock reduction, the requirement is burdensome to the lender (requiring two mailings, one notice and one forwarding the stock retirement proceeds) and does not materially benefit the borrower (who would not normally decide to refinance because of a stock and effective interest rate reduction).

We agree with FCC that prior notice of a decrease in required stock ownership does not provide any meaningful benefit to borrowers. We also believe that the Act does not require a notice for a decrease in stock ownership requirement. Therefore, the proposed rule does not require any notice for a decrease in stock ownership.

However, we believe that the Act requires a lender to make a new EIR disclosure if it increases a borrower's stock purchase requirement because of the need to show the effect of any ''purchases'' of stock on the EIR. Ten-day (10-day) prior notice of such a change is necessary to give a borrower the opportunity to refinance using a meaningful comparison of interest rates. Therefore, the proposed rule retains the 10-day prior notice requirement for any required increase in stock ownership and includes the same basic information requirements as the current regulation. This obligation should not create a burden on System lenders since a stock increase is typically applicable to borrowers of new loans rather than applied retroactively to existing borrowers.

Subpart C—Disclosure of Differential Interest Rates

Section 617.7200—What Disclosures Must a Qualified Lender Make to a Borrower on Loans Offered With More Than One Rate of Interest?

Under the Act, qualified lenders that offer loans with differential interest rates must disclose additional information to borrowers at the request of a borrower of a loan. This requirement was implemented by existing § 614.4368, which requires a lender to inform borrowers of their rights when the lender offers more than one rate of interest to borrowers. We rearranged the existing regulation and moved it to the proposed § 617.7200 without changes in substance.

IV. Calculation of the Effective Interest Rate Using a Discounted Cash Flow Method

To illustrate how discounted cash flows can be used in determining a loan's effective interest rate, we developed the following examples using computer spreadsheet software based on a given set of assumptions to determine the cash flow stream in the calculation.

We assumed that the borrower's stock is not retired either as the loan is paid down or at maturity. We also assumed the future cash flow stream consists of a series of annual equal payments for calculation of the effective interest rate.

The amount of a lender's loan disbursement to the borrower is the loan amount reduced by the borrower's payments for borrower stock and loan origination charges, regardless of the form of the payments. However, depending on how the borrower stock and loan origination charges are paid by the borrower in a loan transaction, the amount of the promissory note to be used for calculation of the EIR may be different.

The following examples demonstrate a loan transaction with two different loan disbursement scenarios: Consider a 10-year, $100,000 loan with a stated interest rate of 9 percent and equal annual payments until maturity. The loan has a $1,000 stock purchase requirement (the lesser of $1,000 or 2 percent of the loan amount) and a $200 loan origination charge. In Example A, we have assumed that the borrower has paid for the stock and fees at the time the loan is disbursed. As a result, the borrower takes a $100,000 loan but only receives loan proceeds of $98,800 ($100,000 loan minus $1,200 stock and loan origination fee). In example B, we have assumed the borrower has rolled the cost of the stock and loan origination fee into the promissory note. In order to receive loan proceeds of $100,000, the borrower needs to take $101,200 loan.

EXAMPLE A.—LOAN PROCEEDS OF $98,800 TO BORROWER WITH A PROMISSORY NOTE OF $100,000

Loan proceeds to borrower	$98,800
Stock purchase	$1,000
Origination fee	$200
Promissory note	$100,000
Interest rate	9.00%
Term of loan	10 years
Annual payment	$15,582
Effective interest rate	9.2752%

The initial cash flow we used in determining the EIR includes: (1) The principal of the loan; (2) the amount of stock a borrower is required to purchase; and (3) the amount of loan origination charges a borrower is required to pay.

In computing the effective interest rate, the first step is to determine the cash flow stream for the loan to maturity. The first in the series of cash flows is the loan disbursement or the loan proceeds to the borrower. In Example A, the amount of loan disbursement to the borrower is determined by taking the gross loan amount of $100,000 minus the stock purchase of $1,000 and the loan origination fee of $200 for a total of $98,800. Thus, the borrower's legal obligation is $100,000, but the borrower only has the use of $98,800—this is the present value from which the effective interest rate on the loan is derived.

The remainder of the cash flow stream consists of the annual payments on the loan to maturity. Microsoft Excel's [6] Payment (PMT) function was used to calculate the constant payment based on the amount of loan to be repaid (*i.e.*, $100,000), the interest rate (9 percent), and the number of payments in the loan term (10). The amount of annual level payments derived from these given factors is $15,582.

Once the cash flow stream has been determined, Excel's Internal Rate of Return (IRR) function is used to calculate the loan's effective interest rate. The effective interest rate for the loan derived from the IRR function is 9.2752 percent [7] (based on the initial cash outflow of $98,800 and a future cash inflow stream consisting of 10 level

[6] We used Microsoft Excel application software to develop these examples. However, the same results can be achieved using other commercially available software.

[7] For illustration purposes, the EIR is expressed in four decimal points in our examples. However, the EIR may be expressed with two or more decimal points based on the size, term, and common industry practice for similar loans.

payments in the amount of $15,582 each year). The IRR reflects the effective interest rate of a loan consisting of disbursements (negative values for cash outflows) and loan payments of principal and interest (positive values for cash inflows) that occur at regular intervals.

EXAMPLE B.—LOAN PROCEEDS OF $100,000 TO BORROWER WITH A PROMISSORY NOTE OF $101,200

Loan proceeds to borrower	$100,000
Stock purchase	1,000
Origination fee	200
Promissory note	101,200
Interest rate	9.00%
Term of loan	10 years
Annual payment	$15,769
Effective interest rate	9.2719%

In Example B, the initial cash flow of the loan to be used in the IRR function for calculating the effective interest rate is the $100,000 loan proceeds to the borrower. The amount of total loan obligation used for determination of the annual payment and the amount of annual payments derived from the PMT function are $101,200 ($100,000 + $1,000 + $200) and $15,769, respectively. The effective interest rate in this case is 9.2719 percent.

In addition to the EIR disclosure, a qualified lender may include supplemental disclosures of the effective interest rate using the assumption that borrower stock will be retired upon repayment of the loan or as the loan is paid down. The qualified lender must explain the purpose of the supplemental disclosure and that stock or participation certificates that borrowers are required to purchase are at risk and may only be retired at the discretion of the board of the institution.

V. Regulatory Flexibility Act

Pursuant to section 605(b) of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*), the FCA hereby certifies that the proposed rule will not have a significant economic impact on a substantial number of small entities. Each of the banks in the System, considered together with its affiliated associations, has assets and annual income in excess of the amounts that would qualify them as small entities. Therefore, System institutions are not ''small entities'' as defined in the Regulatory Flexibility Act.

List of Subjects

12 CFR Part 611

Agriculture, Banks, banking, Rural areas.

12 CFR Part 612

Agriculture, Banks, banking, Conflict of interests, Rural areas.

12 CFR Part 614

Agriculture, Banks, banking, Flood insurance, Foreign trade, Reporting and recordkeeping requirements, Rural areas.

12 CFR Part 617

Banks, banking, Criminal referrals, Criminal transactions, Embezzlement, Insider abuse, Investigations, Money laundering, Theft.

For the reasons stated in the preamble, parts 611, 612, 614 and 617 of chapter VI, title 12 of the Code of Federal Regulations are proposed to be amended as follows:

PART 611—ORGANIZATION

1. The authority citation for part 611 continues to read as follows:

Authority: Secs. 1.3, 1.13, 2.0, 2.10, 3.0, 3.21, 4.12, 4.15, 4.20, 4.21, 5.9, 5.10, 5.17, 6.9, 6.26, 7.0–7.13, 8.5(e) of the Farm Credit Act (12 U.S.C. 2011, 2021, 2071, 2091, 2121, 2142, 2183, 2203, 2208, 2209, 2243, 2244, 2252, 2278a–9, 2278b–6, 2279a–2279f–1, 2279aa–5(e)); secs. 411 and 412 of Pub. L. 100–233, 101 Stat. 1568, 1638; secs. 409 and 414 of Pub. L. 100–399, 102 Stat. 989, 1003, and 1004.

Subpart P—Termination of System Institution Status

2. Amend § 611.1223(d)(6) by revising the second sentence to read as follows:

§ 611.1223 Information statement—contents.

* * * * *

(d) * * *

(6) * * * You must explain the effect termination will have on borrower rights granted in the Act and part 617 of this chapter.

* * * * *

3. Amend § 611.1290 by revising the second sentence to read as follows:

§ 611.1290 Continuation of borrower rights.

* * * Institutions that become other financing institutions on termination must comply with the applicable borrower rights provisions in the Act and part 617 of this chapter.

PART 612—STANDARDS OF CONDUCT AND REFERRAL OF KNOWN OR SUSPECTED CRIMINAL VIOLATIONS

4. The authority citation for part 612 continues to read as follows:

Authority: Secs. 5.9, 5.17, 5.19 of the Farm Credit Act (12 U.S.C. 2243, 2252, 2254).

5. Revise the heading of part 612 to read as set forth above.

6. Redesignate §§ 612.2130 through 612.2270 as subpart A and add a heading for subpart A to read as follows:

Subpart A—Standards of Conduct

PART 614—LOAN POLICIES AND OPERATIONS

7. The authority citation for part 614 is revised to read as follows:

Authority: 42 U.S.C. 4012a, 4104a, 4104b, 4106, and 4128; secs. 1.3, 1.5, 1.6, 1.7, 1.9, 1.10, 1.11, 2.0, 2.2, 2.3, 2.4, 2.10, 2.12, 2.13, 2.15, 3.0, 3.1, 3.3, 3.7, 3.8, 3.10, 3.20, 3.28, 4.12, 4.12A, 4.13B, 4.14, 4.14A, 4.14C, 4.14D, 4.14E, 4.18, 4.18A, 4.19, 4.25, 4.26, 4.27, 4.28, 4.36, 4.37, 5.9, 5.10, 5.17, 7.0, 7.2, 7.6, 7.8, 7.12, 7.13, 8.0, 8.5 of the Farm Credit Act (12 U.S.C. 2011, 2013, 2014, 2015, 2017, 2018, 2019, 2071, 2073, 2074, 2075, 2091, 2093, 2094, 2097, 2121, 2122, 2124, 2128, 2129, 2131, 2141, 2149, 2183, 2184, 2201, 2202, 2202a, 2202c, 2202d, 2202e, 2206, 2206a, 2207, 2211, 2212, 2213, 2214, 2219a, 2219b, 2243, 2244, 2252, 2279a, 2279a–2, 2279b, 2279c–1, 2279f, 2279f–1, 2279aa, 2279aa–5); sec. 413 of Pub. L. 100–233, 101 Stat. 1568, 1639.

Subpart K—[Removed]

8. Remove subpart K, consisting of §§ 614.4365 through 614.4368.

Subpart P—Farm Credit Bank and Agricultural Credit Bank Financing of Other Financing Institutions

9. Revise § 614.4560(d) to read as follows:

§ 614.4560 Requirements for OFI funding relationships.

* * * * *

(d) The borrower rights requirements in part C of title IV of the Act, and section 4.36 of the Act, and the regulations in part 617 of this chapter shall apply to all loans that an OFI funds or discounts through a Farm Credit Bank or agricultural credit bank, unless such loans are subject to the Truth in Lending Act, 15 U.S.C. 1601 *et seq.*

* * * * *

PART 617—REFERRAL OF KNOWN OR SUSPECTED CRIMINAL VIOLATIONS

10. The authority citation for part 617 continues to read as follows:

Authority: Secs. 5.9, 5.17 of the Farm Credit Act (12 U.S.C. 2243, 2252).

PART 617—[REMOVED]

§§ 617.1—617.4 [Redesignated as §§ 612.2300—612.2303]

11. Redesignate §§ 617.1 through 617.4 as new *§§ 612.2300 through 612.2303*.

12. Remove part 617.

13. Redesignate newly designated §§ 612.2300—612.2303 as subpart B and add a heading for subpart B to read as follows:

Subpart B—Referral of Known or Suspected Criminal Violations

§ 612.2300 [Amended]

14. Amend newly designated § 612.2300 by removing the reference ''§ 617.2'' each place it appears and add in its place, the reference ''§ 612.2301'' in paragraphs (a), (c), and (e).

15. Add a new part 617 to read as follows:

PART 617—BORROWER RIGHTS

Subpart A—General

Subpart B—Disclosure of Effective Interest Rates

Subpart C—Disclosure of Differential Interest Rates

Authority: Secs. 4.13, 5.9, 5.17 of the Farm Credit Act (12 U.S.C. 2199, 2243, 2252(a)(9)).

Subpart A—General

§ 617.7000 Definitions.

For purposes of this part, the following terms apply:

Adjustable rate loan means a loan where the interest rate payable over the term of the loan may change. This includes adjustable rate, variable rate or other similarly designated loans.

Effective interest rate means a measure of the cost of credit, expressed as an annual percentage rate, that shows the effect of the following costs, if any, on the interest rate on a loan charged by a qualified lender to a borrower:

(1) The amount of any stock or participation certificates that a borrower is required to buy to obtain the loan; and

(2) Any loan origination charges paid by a borrower to a qualified lender to obtain the loan.

Interest rate means the stated contract rate of interest.

Loan means an extension of credit made to a farmer, rancher, or producer or harvester of aquatic products, for any agricultural or aquatic purpose and other credit needs of the borrower, including financing for basic processing and marketing that directly relates to the borrower's operations and those of other eligible farmers, ranchers, and producers or harvesters of aquatic products.

Qualified lender means:

(1) A System institution, except a bank for cooperatives, that makes loans as defined in this section; and

(2) Each bank, institution, corporation, company, credit union, and association described in section 1.7(b)(1)(B) of the Act (commonly referred to as an other financing institution), but only with respect to loans discounted or pledged under section 1.7(b)(1).

Subpart B—Disclosure of Effective Interest Rates

§ 617.7100 Who must make and who is entitled to receive an effective interest rate disclosure?

(a) A qualified lender must make the disclosures required by subparts B and C of this part to borrowers for all loans not subject to the Truth in Lending Act.

(b) For a single loan involving more than one borrower, a qualified lender is required to provide only one set of disclosures to borrowers. All borrowers may designate, in writing, one person who will receive the effective interest rate disclosure. If the borrowers do not designate a particular recipient, the lender may provide the disclosure to at least one of the borrowers who is primarily liable for repayment of the loan.

§ 617.7105 When must a qualified lender disclose the effective interest rate to a borrower?

(a) *Disclosure to prospective borrowers.* A qualified lender must provide written effective interest rate disclosure for each loan no later than the time of loan closing.

(b) *Disclosure to existing borrowers.* (1) A qualified lender must provide a new effective interest rate disclosure to an existing borrower on or before the date:

(i) The borrower executes a new promissory note or other comparable evidence of indebtedness;

(ii) The borrower purchases additional stock as a condition of obtaining new funds from the qualified lender; or

(iii) The borrower pays an additional loan origination charge to the qualified lender as a condition of obtaining new funds.

(2) A qualified lender is not required to provide a new effective interest rate disclosure when it advances new funds to an existing borrower if none of the conditions of paragraph (b)(1) of this section apply and the advance is made pursuant to a preexisting contract that specifically provides for future advances.

§ 617.7110 How should a qualified lender disclose the cost of borrower stock or participation certificates?

The cost of borrower stock must be included in the effective interest rate calculation at the time the stock is purchased in connection with a loan transaction. For subsequent loans to existing borrowers, only the cost of new stock, if any, purchased in connection with a new loan or advance of new funds must be included in the effective interest rate calculation for the transaction.

§ 617.7115 How should a qualified lender disclose loan origination and other charges?

(a) Any one-time charge paid by a borrower to a qualified lender in consideration for making a loan must be included in the effective interest rate as a loan origination charge. These include, but are not limited to, loan origination fees, application fees, and conversion fees. Loan origination charges also include any payments made by a borrower to a qualified lender to reduce the interest rate that would otherwise be charged, including any charges designated as ''points.''

(b) All other payments of fees not included in the loan origination charges described in paragraph (a) of this section that borrowers are required to make to obtain a loan must be disclosed separately at the time of loan closing. These include, but are not limited to, fees paid to the lender or a third party to obtain an appraisal, and any taxes, guarantee fees, or insurance premiums paid by borrowers to third parties.

§ 617.7120 How should a qualified lender present the disclosures to a borrower?

A qualified lender must:

(a) Disclose the effective interest rate and other information required by subparts B and C of this part clearly and conspicuously in writing, in a form that is easy to read and understand and that the borrower may keep; and

(b) Not combine the disclosures with any information not directly related to the information required by §§ 617.7130 and 617.7135.

§ 617.7125 How should a qualified lender determine the effective interest rate?

(a) A qualified lender must calculate the effective interest rate on a loan using the discounted cash flow method showing the effect of the time value of money.

(b) For all loans, the cash flow stream used for calculating the effective interest rate of a loan must include:

(1) Principal and interest;

(2) The cost of stock or participation certificates that a borrower is required to purchase in connection with the loan; and

(3) Loan origination charges described in § 617.7115(a).

(c) A qualified lender must establish policies and procedures for EIR disclosures that clearly show the effect of the cost of borrower stock and loan origination charges on the interest rate of a loan. A qualified lender must also establish policies and procedures for determining major assumptions used in calculating the effective interest rate, *e.g.*, criteria on how the cost of borrower stock and loan origination charges are assigned or allocated among multiple loans obtained by a borrower simultaneously.

§ 617.7130 What initial disclosures must a qualified lender make to a borrower?

(a) *Required disclosures—in general.* A qualified lender must disclose in writing:

(1) The interest rate on the loan;

(2) The effective interest rate of the loan;

(3) The amount of stock or participation certificates that a borrower is required to purchase in connection with the loan and included in the calculation of the effective interest rate of the loan;

(4) All loan origination charges included in the effective interest rate;

(5) All other charges not included as loan origination charges in the effective interest rate calculation that borrowers are required to pay to obtain a loan;

(6) That stock or participation certificates that borrowers are required to purchase are at risk and may only be retired at the discretion of the board of the institution; and

(7) The various types of loan options available to borrowers, with an explanation of the terms and borrower rights that apply to each type of loan.

(b) *Adjustable rate loans.* A lender must provide the following information for adjustable rate loans in addition to the requirements of paragraph (a) of this section:

(1) The circumstances under which the rate can be adjusted;

(2) How much the rate can be adjusted at any one time and how much the rate can be adjusted during the term of the loan;

(3) How often the rate can be adjusted;

(4) Any limitations on the amount or frequency of adjustments; and

(5) The specific factors that the qualified lender may take into account in making adjustments to the interest rate on the loan.

§ 617.7135 What subsequent disclosures must a qualified lender make to a borrower?

(a) *Notice of interest rate change.* (1) A qualified lender must provide written notice to a borrower of any change in interest rate on the borrower's existing loan, containing the following information:

(i) The new interest rate on the loan;

(ii) The date on which the new rate is effective; and

(iii) The factors used to adjust the interest rate on the loan.

(2) If the borrower's interest rate is directly tied to a widely publicized external index, a qualified lender must provide written notice to the borrower of the rate change within forty-five (45) days after the effective date of the change.

(3) If the borrower's interest rate is not directly tied to a widely publicized external index, a qualified lender must send written notice to the borrower of the rate change within ten (10) days after the effective date of the change.

(b) *Notice of increase in stock purchase requirement.* If a qualified lender increases the amount of stock or participation certificates a borrower must own during the term of a loan, the lender must send a written notice to borrower at least ten (10) days prior to the effective date of the increase. The notice must state:

(1) The new effective interest rate on the outstanding balance for the remaining term of the borrower's loan;

(2) The date on which the new rate is effective; and

(3) The reason for the increase in the borrower stock purchase requirement.

Subpart C—Disclosure of Differential Interest Rates

§ 617.7200 What disclosures must a qualified lender make to a borrower on loans offered with more than one rate of interest?

A qualified lender that offers more than one rate of interest to borrowers must notify each borrower of the right to request a review of the interest rate charged on his or her loan no later than the time of loan closing. At the request of a borrower, the lender must:

(a) Provide a review of the loan to determine if the proper interest rate has been established;

(b) Explain to the borrower in writing the basis for the interest rate charged; and

(c) Explain to the borrower in writing how the credit status of the borrower may be improved to receive a lower interest rate on the loan.

Dated: January 29, 2003.

Jeanette C. Brinkley,

Secretary, Farm Credit Administration Board.

[FR Doc. 03–2401 Filed 2–3–03; 8:45 am]

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FARM CREDIT ADMINISTRATION

12 CFR Parts 609, 614, 615, and 617

RIN 3052–AB69

Electronic Commerce; Loan Policies and Operations; Funding and Fiscal Affairs, Loan Policies and Operations, and Funding Operations; Borrower Rights

AGENCY: Farm Credit Administration (FCA).

ACTION: Proposed rule.

SUMMARY: These proposed rules clarify existing provisions, respond to comments, and reorganize the rules into a separate section of FCA (agency, we, or our) regulations. This update will help agricultural borrowers and institutions of the Farm Credit System (FCS or System) better understand the rights Congress afforded applicants and borrowers of the System. We intend for the proposal to clarify how FCS institutions should apply these rights to applicants and borrowers.

DATES: Written comments should be received on or before April 7, 2003.

ADDRESSES: You may submit comments by electronic mail to *''reg–comm@fca.gov''* or through the Pending Regulations section of our Web site at *''http://www.fca.gov.''* You may also mail or deliver written comments to Thomas G. McKenzie, Director,