

INTERPRETIVE LETTER 94-005 (APRIL 12, 1994)

Finance company may offer installment loans and retail installment loans with variable interest rates for resale to Illinois banks, subject to requirement that payments are made in periodic equal amounts.

The letter from * to the Illinois Commissioner of Banks and Trust Companies ("Commissioner") has been referred to me for response. In it he asked whether Illinois law permits variable interest rates to be used in installment loans and retail installment contracts.

* stated that * Corporation of * ("Finance Company") finances the purchase of recreational vehicles, marine craft, and manufactured homes and wishes to sell the installment contracts to Illinois banks and work with those banks on direct financing. Finance Company would like to structure the agreements to use variable interest rates with installment loans and retail installment contracts in which the monthly payments would increase or decrease as the interest rate changed. We conclude that Illinois law permits the use of variable rates of interest in installment loans and retail installment contracts but that there are significant limitations that are addressed later in this letter.

Disclosure Requirements

Section 4a of the Illinois Interest Act, 815 ILCS 205/4a (1992) (a copy of which is attached hereto), governs installment loans that are not in excess of \$25,000 excluding interest and which are made directly by the bank.

The Motor Vehicle Retail Installment Sales Act, 815 ILCS 375/1 et seq. (1992) ("MVRISA"), governs retail installment contracts for the purchase of motor vehicles, including recreational vehicles.

The Retail Installment Sales Act, 815 ILCS 405/1 et seq. (1992) ("RISA"), governs retail installment contracts for the sale of other personal property. See ' ' 2.11(1), 5(8), and 5(11) of RISA (a copy of which is attached hereto).

The Interest Act, MVRISA, and RISA each require the lender or dealer to disclose the amount of interest that will be charged on an installment loan or contract, the number of payments, the amount of each payment, and the total amount of payments. While disclosure provisions set forth in these statutes only describe computations for fixed rate loans, they do provide that compliance with the disclosure requirements of the federal Truth in Lending Act, 15 U.S.C. ' 1601 et seq. ("TILA"), and regulations issued thereunder will be treated as compliance with the disclosure requirements of those respective acts. See 815 ILCS 205/4a(i)(1992), 815 ILCS 375/5(1992), and 815 ILCS 405/5(1992).

Regulation Z

The Board of Governors of the Federal Reserve System has issued Regulation Z, 12 C.F.R. ' 226.1 et seq., to implement TILA. Regulation Z provides that creditors, including banks, may use variable rates of interest in closed-end transactions as long as there is proper disclosure. See 12 C.F.R. ' 226.18(f). For closed-end transactions that are not secured by the consumer's principal residence or that are secured by the consumer's principal residence for a duration of one year or less, Regulation Z requires the following disclosures be made when a creditor uses a variable annual percentage rate:

- 1) The circumstances under which the rate may increase;
- 2) Any limitations on the increase;
- 3) The effect of an increase; and
- 4) An example of the payment terms that would result from an increase. 12 C.F.R. ' 226.18(f)(1).

In closed-end transactions that are secured by the consumer's principal residence for a duration of more than one year, Regulation Z requires the following disclosures be made when a variable annual percentage rate is involved:

- 1) The fact that the transaction contains a variable-rate feature; and
- 2) A statement that variable-rate disclosures have been provided earlier. 12 C.F.R. ' 226.18(f)(2).

Consequently, as long as the disclosures of Sections 226.18(f)(1) or (2) are given to a borrower in a closed-end credit transaction involving a variable rate of interest, the creditor will be treated as having complied with the disclosure requirements of the Interest Act, MVRISA, and RISA.

Variable Interest Rates

The Interest Act restricts the use of a variable rate of interest for a credit transaction that is secured by a mortgage on residential real estate. See ' 4(2)(b) of the Interest Act, 815 ILCS 205/4(2)(b). In this situation, a creditor may use a variable rate of interest only to the extent authorized by Congress or a federal agency to any class of lender. In other types of credit transactions governed by the Interest Act, a creditor may use a variable rate of interest subject to the usury limit, if applicable.

Section 6 of both MVRISA and RISA limit the use of a variable rate of interest in a credit transaction. See 815 ILCS 375/6 (1992) and 815 ILCS 405/6 (1992) (a copy of which is attached hereto). Section 6 of each statute requires that payment be made in "periodic,

equal amounts (emphasis added)" until the contract matures. Therefore, contracts governed by MVRISA or RISA may not provide that the payment amount increases or decreases to account for an increase or decrease in the interest rate. However, a variable rate of interest may be provided in contracts governed by those statutes by extending or shortening the contract's maturity as the interest rate increases or decreases, while leaving the monthly installments the same.

If Finance Company works with national banks in Illinois, we recommend that you contact the Office of the Comptroller of the Currency, the primary regulator of national banks, regarding variable interest rates on installment loans and retail installment contracts that national banks may hold.