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# Department of Justice

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- RE: \*
- \* Whether ICCA § 537.2504 permits capitalizing accrued, unpaid interest upon refinancing a closed-end balloon transaction;
  - \* Whether ICCA § 537.2402 permits capitalizing accrued, unpaid interest on open-end loans.

Dear

Thank you for your inquiry.

While your questions speak only to technical, accounting procedures permissible under the I-CCA, I would like to take the opportunity to address the issues both as to text and context.

**Refinancing A Closed-End Balloon Loan:**

This discussion assumes that the transaction is one in which a balloon payment is authorized.<sup>1</sup>

As a general matter, the code provides that the appropriate method of determining the finance charge on closed-end transactions is the actuarial method. Iowa Code § 537.2401(1). The actuarial method does permit accrued, unpaid interest to be capitalized. Iowa Code § 537.1301(1); see also Reg. Z § 226 Appx. J(a)(2).<sup>2</sup>

<sup>1</sup> The I-CCA limits the situations in which transactions may contain a balloon payment. Iowa Code § 537.3308. Additionally, the Home Ownership and Equity Protection Act (HOEPA) includes a limitation on balloon payments for closed-end home equity loans which pass certain high-cost threshold triggers. See 15 U.S.C. § 1639, esp. §1639(e).

<sup>2</sup> Appx. J(a)(1) and (2) explain the distinction between the actuarial rule and the US rule for treatment of accrued, unpaid interest.

Further, Iowa Code § 537.2504(1) specifically defines the amount financed to include "accrued charges, including finance charges" on that date of refinancing. Hence, it is permissible under the Code to compound earned, but unpaid interest upon refinancing.

**Compounding interest on open-end transactions:**

Your second question involved compounding interest on non-credit card open-end loans. You indicate that the open-end program Transamerica is considering is a loan, not a sale, and does not negatively amortize. You do not say whether it is a home-secured open-end line, however.

**HELCS:** Iowa Code § 535.10(2) provides that Iowa Code § 537.2402 does not apply to HELCS. The allowable rate on a HELC is 1.75% per month, Iowa Code § 535.10(4). That section does not explicitly adopt the actuarial rule, but two of the definitional elements suggest that actuarial accrual is contemplated. Section 535.10(1)(a) and (b) define a HELC as an arrangement where "the amounts borrowed and the interest and other charges are debited to an account" and "the interest is computed on the account periodically."

However, it also appears that under Iowa law, compounding must be authorized by a specific provision in the contract.<sup>3</sup> Absent such a qualifying contractual provision, Transamerica would have to follow the U.S. Rule, and not capitalize the accrued, unpaid interest.<sup>4</sup>

**Non-HELCS open-end loans:** Under Iowa Code § 537.2402, creditors have their choice of applying the interest rate to a principal balance which does not exceed the greatest of three different methods.

The first is the average daily balance method, by which any unpaid purchases "and other debits" are added to the balance. Since the maximum amount is determinable by reference to the method which yields the "greatest" principal, it would seem that capitalizing accrued, unpaid interest is acceptable under Iowa Code § 537.2402.

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<sup>3</sup> "Compounding is prohibited absent an agreement between the parties which speaks directly to the matter of compounding." *Power Equipment, Inc. v. Tschiggfrie*, 460 N.W.2d 861, 864 (Iowa 1990).

<sup>4</sup> See 12 C.E.R. § 226 Appx. J(a)(3). (At the risk of appearing to shill for a former employer, the National Consumer Law Center, *The Cost of Credit: Regulation & Legal Challenges* Chap. 4 (1995) has considerable discussion of credit math issues, including compounding, § 4.6.1.)

In sum, as a matter of text, capitalizing accrued, unpaid interest in these situations would appear to be acceptable, at least so long as the contract authorizes it.

As noted above, however, I wanted to alert you, as counsel for Transamerica, that it is increasingly becoming as important to look at the context in which consumer credit programs are being used as it is to look at the text of the applicable statutes.

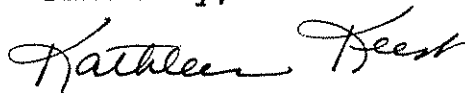
For example, if the transactions are HELCs which, as a result of their cost, would be subject to HOEP if they were closed-end they are likely to be closely scrutinized to determine whether they are genuine open-end transactions, or are "spurious" open-end transactions designed to evade laws which give more useful information or greater protections to closed-end consumers. Cf. Pub. L. No. 103-325, Title I, § 158 (passed as part of HOEP, but not codified in U.S.C.).

Similarly, balloon notes have been the subject of close scrutiny in individual circumstances where the repayment terms, in relation to the consumer's financial circumstances, suggest "equity-skimming." See "Problems in Community Development Banking, Mortgage Lending Discrimination, Reverse Redlining, and Home Equity Lending," Hearings Before the Senate Comm. on Banking, Housing and Urban Affairs, 103d Cong., 1st Sess. (Feb. 3, 17, 24, 1993).

This is not to suggest, of course, that your questions raised any suggestion that such problems exist with the proposed program. However, we did want you to be aware of this possible added dimension.

If you have further questions, please feel free to call.

Sincerely,



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