STATE OF TEXAS

OFFICE OF CONSUMER CREDIT COMMISSIONER

SAM KELLEY, Commissioner

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June 12, 1981 No. 81-5

Mr. Cullen A. Rogers
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Dallas Federal Savings
& Loan Association
Corporate Headquarters
8333 Douglas, P.O. Box 12709
Dallas, Texas 75225

Re: Request for Official Interpretation under Title 79, Interest, Texas Revised Civil Statutes, As Amended by HB 1228

Dear Mr. Rogers:

In your letter of May 19, 1981, you requested an official interpretation of certain provisions of Chapters 1 and 5, Art. 5069, V.A.C.S. as amended by HB 1228 during the 67th Texas legislative session. Both the hypothetical case you presented and your question are restated verbatim below:

> "Hypothetical case: Under authority of the referenced provisions, a lender charges a rate of interest on a precomputed, add-on basis which gives the lender a yield which is authorized by Articles 5.02(6) and 1.04 at the time the loan is made."
>
> "Question: In the event of prepayment in full, may the lender use the 'Rule of 78s', as described in Article 5.02(4), to calculate the refund to the borrower if the resulting yield to the lender, after any such prepayment in full and refund, is greater than the yield that was authorized by Articles 5.02(6) and 1.04 at the time the loan was made?"

In order to avoid any misunderstanding as to our analysis of the effects of the amendments to the Texas Credit Code occasioned by the passage of HB 1228, I feel we should first clarify for purposes of this reply our definition of the various descriptive or technical terms used in your letter and in this response.

The use of the term "precomputed" refers to the type of transaction that is described in Article 5.02(2); i.e. interest is computed on the cash advance (amount financed) at the time the loan is made for the full term of the loan contract and the amount of interest is added to the cash advance to arrive at the amount of the loan (total of payments).

The term "add-on" refers to a percentage added on to an amount. The rate of interest authorized in Article 5.02(1) is expressed in terms of dollars per one hundred and may be referred to as an eight percent (8%) add-on rate.

A "simple interest" contract rate as that term is used in Article 1.04(n)(4) is intended to refer to a rate of finance charge that is to be applied to an unpaid principal balance of a contract from time to time. Such a contract is opposite in construction to the precomputed type transaction, and is also referred to as an "interest bearing transaction".

The "Rule of 78" method of calculating refunds is a practical way of allocating earnings and computing rebates for monthly installment loans. However, the application of this method of refunding results in only an approximation of the true earnings (if amortized) and its usage is appropriate only when the outstanding balances of a transaction are scheduled to be reduced each monthly installment period by a same amount; i.e. all scheduled monthly installments are substantially equal. This method of calculation employs the use of the number of monthly installments in the repayment schedule of a contract rather than the amount(s) of periodic balances as used in the refunding method described in Article 5.02(4).

The "Sum of the Periodic Balances" method of refunding is a descriptive term which has been utilized by this Office as a short title reference to the calculations described in Article 5.02(4). This refunding method requires the use of the amounts of periodic balances to determine earned/unearned interest charges. If all scheduled monthly installments under a contract are equal, then the sum of all the periodic balances will reduce in a like amount each installment period and any refundable amount will be identical to that produced by the Rule of 78 method. However, if one or more of the scheduled installments are not substantially equal to all of the other installments, the Sum of the Periodic Balances method of computation will not produce precisely the same amount of refund as will be produced by the Rule of 78 method.

It is the opinion of this Office that any statutory authority to utilize a stipulated method to determine refunds and earnings may also be construed as a preemptive authority to receive a rate of charge (yield) greater than that otherwise permitted under the statute if the prescribed

refunding method has the effect of producing accelerated earnings in the event of the prepayment in full of the indebtedness. Assume a precomputed loan has been made pursuant to Chapter 5 of the Code at the maximum ceiling rate of twenty-four percent (24%) permitted by Article 1.04. If the loan is prepaid in full and the refunding method prescribed in Article 5.02(4) is utilized, the amount of the lawfully retained interest will probably produce an interest yield (rate of return) greater than twenty-four percent (24%). Even so, the transaction should not be considered usurious. Prepayments that occur during the earlier life of the contract produce the greatest disparity between the original contract rate and the yield rate.

We do not agree with your conclusion that the Rule of 78 method of refunding can be used in the event of the prepayment in full of any precomputed loan made pursuant to Chapter 5. The phrase "... substantially equal in amount ..." which is found in Article 5.02 has been omitted from Article 1.04(n)(2). Consequently, a loan that otherwise qualifies under Chapter 5 may be scheduled to be repaid in other than substantially equal monthly installments and thus would not qualify as a transaction to which the Rule of 78 refunding method would be appropriate. The Sum of the Periodic Balances method of refunding may be used in such an instance.

I might add that we have received numerous inquiries as to whether the repayment schedule for a Chapter 5 loan can include a balloon payment. Inasmuch as the Article 1.04(n)(2) provision does not include a restriction as to the amount of each monthly installment we conclude that the inclusion of a balloon payment in the repayment schedule of a Chapter 5 loan is permissible.

It is obvious that the authority in Article 1.04(n)(2) to arrange simple interest loans under Chapter 5 creates a type of transaction that is completely foreign to the existing provisions of the Chapter. In order to properly administer this part of Article 5069, we must basically rely on the known legislative history and intent and, hopefully, some degree of logic to arrive at our position with respect to charges and earnings in connection with interest bearing loans made pursuant thereto. The contents of Article 5.02(3) relating to default and deferment charges were obviously written to be applicable to precomputed type loans. The original language of Articles 3.15(5) and 4.01(5) was identical to that which now exists in Article 5.02(3) (except for references to Sections), but the provisions of those Articles (3.15(5) and 4.01(5)) were amended in 1979 so as to limit the default and deferment charge authority to those loans which include precomputed interest. Chapter 5 was not amended in a like manner at the same time since only precomputed loans could be made under Chapter 5. Therefore, we feel that the absence of the qualifying language "On any loan contract which includes precomputed interest ..." (as found in Articles 3.15(5) and 4.01(5)) should not be construed as an intent on the part of the legislature to authorize a

default charge as an additional charge which can be assessed on an interest bearing loan made pursuant to Chapter 5 but which charge is not authorized for the same "type" of loan made under either Chapter 3 or Chapter 4. We do not consider either a default charge or a deferment charge as being authorized in connection with an interest bearing (simple interest) loan made pursuant to Chapter 5.

The refunding provision of Article 5.02(4) can only be applicable to a transaction that involves precomputed interest. For interest bearing transactions (simple interest) made pursuant to Chapter 5, we consider the following provisions of Articles 3.15(6)(b) and 4.01(6)(b) to be the stated concept for interest earnings under the Code and is applicable to such Chapter 5 transactions:

> "If the loan contract does not contain precomputed interest, then interest may be earned on the principal balance, including additions to principal subsequent to the loan contract from time to time unpaid at the rate contracted for, until the date of payment in full or demand for payment in full."

I realize I have expanded this response beyond your basic inquiry, but I believe all the contents of this letter are pertinent to the subject. If you have any further comments or suggestions, please let me know.

Yours very truly,

Sam Kelley

Sam Kelley
Consumer Credit Commissioner