FEDERAL RESERVE BANK
OF DALLAS

ROBERT D. McTEER, JR.
PRESIDENT
AND CHIEF EXECUTIVE OFFICER

DALLAS, TEXAS
75265-5906

October 25, 1996

Notice 96-100

TO: The Chief Executive Officer of each financial institution and others concerned in the Eleventh Federal Reserve District

SUBJECT

Final Amendments to Regulation Z (Truth in Lending)

DETAILS

The Board of Governors of the Federal Reserve System has announced the adoption of final amendments to Regulation Z (Truth in Lending).

The revisions to Regulation Z incorporate changes made by the Truth in Lending Act Amendments of 1995. The amendments establish new creditor-liability rules for closed-end loans secured by real property or dwellings consummated on or after September 30, 1995. The amendments also clarify how lenders must disclose certain fees connected with mortgage loans.

In addition, the Board is publishing a new rule regarding the treatment of fees charged in connection with debt cancellation agreements. The rule is similar to the existing rule regarding credit insurance premiums, and provides for more uniform treatment of these fees. The Board's amendments became effective October 21, 1996.

ATTACHMENT

A copy of the Board's notice as it appears on pages 49237-48, Vol. 61, No. 183, of the *Federal Register* dated September 19, 1996, is attached.

MORE INFORMATION

For more information, please contact Eugene Coy at (214) 922-6201. For additional copies of this Bank's notice, please contact the Public Affairs Department at (214) 922-5254.

Sincerely yours,

Robert D. McTeer, Jr.

Rules and Regulations

Federal Register
Vol. 61, No. 183
Thursday, September 19, 1996

FEDERAL RESERVE SYSTEM

12 CFR Part 226

[Regulation Z; Docket No. R–0927]

Truth in Lending

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final rule.

SUMMARY: The Board is publishing revisions to Regulation Z (Truth in Lending). The revisions implement the Truth in Lending Act Amendments of 1995, which establish new creditor-liability rules for closed-end loans secured by real property or dwellings and consummated on or after September 30, 1995. The 1995 Amendments create several tolerances for accuracy in disclosing the amount of the finance charge, and creditors have no civil or administrative liability if the finance charge and affected disclosures are within the applicable tolerances. The amendments also clarify how lenders must disclose certain fees connected with mortgage loans. In addition, the Board is publishing a new rule regarding the treatment of fees charged in connection with debt cancellation agreements, which is similar to the existing rule for credit insurance premiums and provides for more uniform treatment of these fees.

DATES: This rule is effective October 21, 1996.

FOR FURTHER INFORMATION CONTACT: James A. Michaels, Senior Attorney, or Natalie E. Taylor or Michael L. Hentrel, Staff Attorneys, Division of Consumer and Community Affairs, Board of Governors of the Federal Reserve System, at (202) 452–3667 or 452–2412; users of Telecommunications Device for the Deaf (TDD) *only,* contact Dorothea Thompson at (202) 452–3544.

SUPPLEMENTARY INFORMATION:

I. Background

The purpose of the Truth in Lending Act (TILA) (15 U.S.C. 1601 *et seq.*) is to promote the informed use of consumer credit by requiring disclosures about its terms and cost. The act requires creditors to disclose the cost of credit as a dollar amount (the "finance charge") and as an annual percentage rate (the "APR"). Uniformity in creditors' disclosures is intended to assist consumers in comparison shopping.

The TILA requires additional disclosures for loans secured by a consumer's home and permits consumers to rescind certain transactions that involve their principal dwelling. The act is implemented by the Board's Regulation Z (12 CFR part 226).

II. Regulatory Provisions

On September 30, 1995, the Congress enacted the Truth in Lending Act Amendments of 1995 (1995 Amendments), Pub. L. 104–29, 109 Stat. 271. The 1995 Amendments address the concerns of mortgage lenders stemming from a 1994 court decision, *Rodash* v. *AIB Mortgage Co.*, 16 F.3d 1142 (11th Cir. 1994). In that case, the U.S. Court of Appeals affirmed a district court opinion that allowed a consumer to rescind a home mortgage loan and recover all fees and finance charges that had been paid, based in part on errors in the creditor's TILA disclosures. Subsequently, a number of class action lawsuits were filed, involving thousands of mortgage loans, alleging similar violations and seeking the remedy of rescission.

In response to mortgage lenders' concerns about their potential liability for finance charge violations that they viewed as minor, the Congress enacted a temporary moratorium on such litigation, which has now been replaced by the 1995 Amendments. The Amendments establish new liability rules for loans consummated before and after September 30, 1995, establish a new rule that includes mortgage broker fees in the finance charge disclosure, and clarify the proper treatment of other fees. In May 1996, the Board published proposed regulations to implement the amendments with respect to loans made after September 30 (61 FR 26126).

The Board is also amending Regulation Z to provide a rule addressing the treatment of fees charged in connection with debt cancellation agreements, which serve purposes similar to credit insurance. A specialized form of debt cancellation agreement, known as guaranteed automobile protection or "GAP," is also covered by the new rule. In response to public comments, the final rule has been modified slightly from the May 1996 proposal.

Finally, the Board is making a technical amendment to the definitions of "business day" in Regulation Z, 12 CFR 226.2(a)(6). For clarity, the Board has amended the definitions of "business day" to include a specific reference to subpart E.

Under the 1995 Amendments, the statutory provision treating mortgage broker fees as finance charges becomes effective on September 30, 1996. The other provisions of the 1995 Amendments became effective upon the law's enactment on September 30, 1995. The Board believes that revisions to Regulation Z do not impose any additional disclosure requirements beyond those already required under the statute, as amended. Accordingly, the revisions to Regulation Z will become effective on October 21, 1996.

The new rule on debt cancellation fees will also become effective on October 21. The rule imposes no additional disclosure requirements. Creditors must continue to treat debt cancellation fees as finance charges; when the new rule becomes effective creditors will have the option of excluding voluntary debt cancellation fees from the finance charge if they meet the specified requirements.

III. Section-by-Section Analysis

Subpart A—General

Section 226.2—Definitions and Rules of Construction

2(a) Definitions

2(a)(6)

Paragraph (2)(a)(6) is adopted as proposed. For purposes of the Board's rules implementing the Home Ownership and Equity Protection Act of 1994 in Subpart E of Regulation Z, the "business day" definition for rescission applies. The Board has also updated the list of legal public holidays to include the Birthday of Martin Luther King, Jr.

Section 226.4—Finance Charge

4(a)(1) Charges by Third Parties

Paragraph 4(a)(1) reflects the general rule for third party charges currently contained in comment 4(a)–3 of the Official Staff Commentary. A slight modification has been made for clarity. In general, amounts charged by third parties are included in the finance charge if the creditor requires the use of the third party or retains any portion of the charge (in which case the portion retained is included as a finance charge).

4(a)(2) Special Rule; Closing Agent Charges

Paragraph 4(a)(2) incorporates the substance of section 2(a) of the 1995 Amendments, and is consistent with the existing interpretation in comment 4(a)–4 of the Official Staff Commentary. Under the rule, a fee charged by a third-party closing agent is included in the finance charge only if the creditor requires the imposition of the charge or the provision of the service, or retains any portion of the charge. Accordingly, a courier fee charged by a third-party closing agent is only a finance charge if the creditor requires the use of the courier (or to the extent the creditor retains a portion of the charge). The rule only applies to the third-party serving as the closing agent with respect to that loan. The final rule has also been modified slightly to clarify the term "closing agent."

4(a)(3) Special Rule; Mortgage Broker Fees

Paragraph 4(a)(3) contains a new rule regarding the treatment of mortgage broker fees, to implement section 106(a)(6) of the TILA (15 U.S.C. 1605(a)(6)), which becomes effective on September 30, 1996. The rule requires that *all* fees charged by a mortgage broker and paid directly by the consumer be included in the finance charge, whether the fee is paid to the broker or to the lender for delivery to the broker. A fee charged by a mortgage broker will be excluded from the finance charge only if it is the type of fee that would also be excluded when it is charged by the creditor. In the case of application fees charged by a mortgage broker, such fees may be excluded from the finance charge if the mortgage broker charges the fee to all applicants for credit, whether or not credit is actually extended.

Several commenters questioned the basis for requiring creditors to disclose, as finance charges, fees that the creditor neither imposes nor requires. They also expressed concern about creditors' duty for including brokers' fees in Truth in Lending disclosures when the existence or amount of such fees may not be known to the creditor.

The new rule is mandated by the 1995 Amendments. Under the Real Estate Settlement Procedures Act (RESPA) (12 U.S.C. 2601 *et seq.*), amounts paid by a consumer directly to a mortgage broker or through the lender for delivery to the mortgage broker are already required to be disclosed to the borrower at the loan closing on the HUD–1 or HUD–1A. *See* 24 CFR part 3500 appendix A, appendix B ¶12. The Board believes that the new TILA disclosure requirement should not pose a significant additional burden, and that it is reasonable to require creditors to use the information from the HUD forms in calculating the finance charge. Accordingly, the Board expects that creditors will adopt practices and procedures consistent with their affirmative obligation to obtain the relevant information from the parties involved.

In the May proposal, the Board noted that fees paid by the funding party to a broker as a "yield spread premium,"

and already included in the finance charge as interest or as points should not be double counted. Several commenters sought further clarification, noting that brokers may be compensated by the lender under various arrangements. The proposal's reference to "yield spread premiums" was only intended to be one example of lender-paid compensation that must be separately disclosed on the HUD–1 under the current RESPA rules, but should not be double counted because it is already included as part of the finance charge.

4(b) Example of Finance Charge

4(b)(10) Debt Cancellation Fees

Debt cancellation agreements serve a purpose similar to credit insurance, even though the products are not identical in all respects. Paragraph 4(b)(10) clarifies that fees charged by creditors for debt cancellation coverage that is written in connection with a credit transaction are considered finance charges. Conditions under which *voluntary* debt cancellation fees may be excluded from the finance charge are set forth in paragraph 4(d)(3).

Comments by some insurance providers noted that the term "debt cancellation agreement" is not commonly used in reference to GAP agreements. For purposes of Regulation Z, however, the term "debt cancellation agreement" is used generically to refer to a contract between a debtor and creditor providing for satisfaction of all or part of the debt when a specified event occurs. This definition includes GAP agreements, even though GAP agreements only cancel the portion of the debt remaining after the application of property insurance benefits.

Some commenters disagreed with the notion that voluntary debt cancellation fees may be considered finance charges, although they generally supported the Board's approach in paragraph 4(d)(3), excluding such fees when appropriate disclosures are provided. Other commenters believed that debt cancellation agreements are an integral part of the loan agreement and argue that such fees are necessarily charged as an incident to the extension of credit, making them finance charges.

The Board believes that a debt cancellation fee charged by the creditor satisfies the definition of a finance charge because it is part of the cost of the credit. The TILA defines a finance charge to include any charge imposed as an incident to the extension of credit. The Board has interpreted this definition to include any fee charged by the creditor in connection with the loan, if it is not charged in comparable cash transactions and is not subject to an express exemption. The Board has generally taken a case-by-case approach in determining whether particular fees are "finance charges," and does not interpret Regulation Z to automatically exclude all "voluntary" charges from the finance charge. As a practical matter, most voluntary fees are excluded from the finance charge under the separate exclusion for charges that are payable in a comparable cash transaction, such as fees for optional maintenance agreements or fees paid to process motor vehicle registrations. In the case of debt cancellation agreements, however, the voluntary nature of the arrangement does not alter the fact that debt cancellation coverage is a feature of the loan affecting the total price paid for the credit.

Thus, even though a lender may not require a particular loan feature, the feature may become a term of the credit if it is included. For example, borrowers obtaining variable-rate loans may have an option to convert the loan to a fixed interest rate at a subsequent date. Even though the lender does not require that particular feature, when it is included for an additional charge (either paid separately at closing or paid in the form of a higher interest rate or points), that amount properly represents part of the finance charge for that particular loan, even though less costly loans may be available without that feature. This is also the case with debt cancellation coverage, which alters the fundamental nature of the borrower's repayment obligation. Although the same loan may be available without that feature, with respect to a loan that has been structured in this manner, the debt cancellation fee is one that has been imposed as an incident to that particular extension of credit. The same rationale applies to premiums for voluntary credit insurance, which generally are finance charges under the TILA but may be excluded if specified disclosures are given.

Creditors have reported significant difficulty in determining the proper treatment of debt cancellation fees under Regulation Z, particularly GAP fees. Because the status of these agreements under state insurance laws and regulations is often unclear, creditors have been unsure whether they may apply the TILA rules excluding certain credit insurance premiums from the finance charge. Those rules permit the cost of credit insurance to be excluded if the purchase is voluntary and certain disclosures are made regarding the terms of the coverage. For the reasons discussed below, the Board has determined that similar treatment for debt cancellation fees is appropriate. Accordingly, paragraph 4(d)(3) provides that debt cancellation fees may be excluded from the finance charge if the disclosures and requirements in that paragraph are satisfied.

4(c) Charges Excluded From the Finance Charge

4(c)(7) Real-Estate Related Fees

4(c)(7)(ii)

Paragraph 4(c)(7)(ii) is revised to implement the amendment to section 106(e)(2) of the TILA (15 U.S.C. 1605(e)(2)). The Board believes that the amendment does not represent a substantive change from the current rule.

4(c)(7)(iii)

Paragraph 4(c)(7)(iii) is revised by deleting the reference to appraisal fees, which is addressed separately in revised paragraph 4(c)(7)(iv).

4(c)(7)(iv)

Former paragraph 4(c)(7)(iv) is redesignated as 4(c)(7)(v). A new paragraph 4(c)(7)(iv) implements section 106(e)(5) of the TILA (15 U.S.C. 1605(e)(5)), which clarifies that fees related to property inspections conducted prior to closing for pest infestation or flood hazard determinations, may be excluded from the finance charge. In response to commenters' suggestions, the language has been modified to reflect that the same rule applies to other types of property inspections conducted as part of the lender's credit decision to assess the value or condition of the property. The revision is consistent with comment 4(c)(7)–3 of the Official Staff Commentary, which states that excluded fees are those charged solely in connection with the initial decision to extend credit. The exclusion does not apply to fees for inspections or services to be performed periodically during the term of the loan.

4(d) Insurance and Debt Cancellation Coverage

4(d)(1) Voluntary Credit Insurance Premiums

Paragraph 4(d)(1)(i) is modified consistent with existing comment 4(d)–1 of the Official Staff Commentary, to clarify that a disclosure that insurance coverage is not required by the creditor must be in writing.

4(d)(3) Voluntary Debt Cancellation Fees

The Board is amending Regulation Z by adding a provision on fees charged for debt cancellation agreements, which serve a purpose similar to credit insurance. The new rule allows creditors to exclude fees for voluntary debt cancellation coverage from the finance charge when specified disclosures are made. In disclosing debt cancellation fees, creditors may *not* use the model forms for insurance premiums unless debt cancellation coverage constitutes insurance under state law.

Under a debt cancellation agreement, the creditor agrees to cancel all or part of any remaining debt in the event of an occurrence, such as the death, disability or unemployment of the borrower. The creditor may or may not purchase insurance to cover this risk. A specific form of debt cancellation known as guaranteed automobile protection, or "GAP," is sold in connection with motor vehicle loans. GAP agreements cancel the remaining debt when the vehicle securing the loan is stolen or destroyed and the settlement payment made by the consumer's primary automobile insurance is insufficient to pay the loan balance.

Previously, debt cancellation fees have not been specifically addressed in Regulation Z. In December 1995, the Board proposed to issue its first written interpretation on the proper treatment of debt cancellation fees under then existing rules. The December interpretation recognized that debt cancellation fees are finance charges paid as an incident to the extension of credit. In some states, debt cancellation coverage may be considered insurance, thus the proposed interpretation noted that in some cases the fees might be excluded from the finance charge in accordance with the existing rules in § 226.4(d) for certain types of insurance premiums. For example, the Board noted that in a state where debt cancellation agreements are considered or regulated as insurance, § 226.4(d)(1) would allow such fees to be excluded from the finance charge if the agreement insures against the death, disability, or loss of income of the borrower and certain disclosures are given. On the other hand, fees for GAP coverage not protecting against the types of risk covered in §§ 226.4(d) (1) and (2) were to be included in the finance charge, as were other types of debt cancellation fees in states where the agreements are not considered to be insurance. The proposed interpretation also noted that charges for insurance protecting the creditor against credit loss are finance charges under section 226.4(b)(5) and may not be excluded under § 226.4(d).

The comments received in response to the proposed December interpretation were mostly negative. Commenters expressed particular concern about the need to make a state-by-state determination of whether such agreements are considered insurance contracts. They noted that reliance on state law would not create a uniform rule for measuring the cost of credit, contrary to the purpose of the TILA. Creditors in some states could quote a lower APR for the same product, which would not assist consumers in comparison shopping. Even within a state that treats debt cancellation agreements as insurance, debt cancellation fees would not be treated uniformly under Regulation Z, which excludes such fees from the finance charge only if the agreement covers loss of life, disability, or unemployment, but not if the agreement covered other contingencies, as in the case of GAP agreements. Moreover, debt cancellation fees and credit insurance premiums would be treated differently for purposes of cost disclosures even though they served a similar purpose to the consumer.

Commenters also expressed concern about the potential compliance risks associated with making a determination about the status of debt cancellation agreements, including GAP, in states where the insurance laws are unclear. Commenters stated that some creditors have refused to make or purchase loans with GAP coverage due to the uncertainty about how fees must be disclosed under the TILA. Several lawsuits have challenged creditors' practices of excluding voluntary GAP fees from the finance charge, although some courts have held that these fees are not finance charges in the absence of a contrary ruling by the Board.

In April 1996, the proposed interpretation was withdrawn to allow the Board to consider amending Regulation Z to provide a separate rule that would explicitly address GAP and other debt cancellation fees. In May 1996, the Board proposed such a rule. The proposed rule did not mirror the withdrawn interpretation which had largely addressed the fees based on the application of the rules for insurance premiums. Instead, the Board proposed to treat debt cancellation agreements in a uniform manner, without regard to their status under state insurance law.

The Board believes that it is important for Regulation Z to promote uniformity in the disclosure of similar credit cost features to assist consumers and to facilitate creditor compliance. Accordingly, the Board is adopting a new rule to specifically address debt cancellation agreements, including GAP agreements. Pursuant to its authority under section 105 of the TILA, the Board is authorized to issue regulations containing such differentiations or exceptions for any class of transactions as in the Board's judgment are proper to effectuate the purposes of the TILA or facilitate compliance with the act. The Board has determined that the rule being adopted, which allows voluntary debt cancellation fees to be excluded from the finance charge when certain disclosures are given, will effectuate the TILA's purpose of providing uniform disclosures to promote comparison shopping and the informed use of credit. The new rule also addresses creditors' difficulties with the existing rules and facilitates compliance with the act.

Comments from credit insurance providers questioned the Board's authority to issue the rule based on a section 106(d)(4) of the original TILA, which was deleted in the Truth in Lending Simplification and Reform Act of 1980 ("Simplification Act"). Section 106 defines the term "finance charge" for purposes of the TILA and former section 106(d)(4) authorized the Board to issue regulations excluding from the finance charge any "type of charge which is *not* for credit" (emphasis added). Insurance providers asserted that the deletion of section 106(d)(4) curtailed the Board's general authority to exclude items from the finance charge by regulation. The Board disagrees with the insurance providers' interpretation.

The Board has express authority to issue the rule on debt cancellation fees under section 105 of the TILA. To the extent that the former section 106(d)(4) may also have provided more specific authority, its deletion merely eliminated an alternate source of authority. The Board believes, however, that these commenters have misinterpreted the purpose of section 106(d)(4) and the reason for the changes made by the Simplification Act. The Simplification Act sought to clarify the statutory definition of a "finance charge" and did so by adding language to expressly exclude from the finance charge, *all* charges "payable in a comparable *cash* transaction." This new statutory exclusion made it unnecessary for the Board to exclude *noncredit* charges on an individual basis by regulation. Thus, the authority originally granted in section 106(d)(4) became obsolete.

There is nothing to suggest that the Simplification Act's revision to section 106 was intended to limit the Board's

general regulatory authority under section 105. Section 106(d)(4) established the Board's authority to exclude charges that were not for credit. The Board's broader authority under section 105 to make exceptions also applies to credit-related charges, and was not affected by the Simplification Act. Debt cancellation fees are credit-related charges that are not payable in comparable cash transactions, and would not have been the type of fees governed by section 106(d)(4).

New paragraph 4(d)(3) closely parallels the existing rule pertaining to credit insurance in § 226.4(d)(1), and excludes fees paid for similar types of debt cancellation agreements, as well as GAP agreements, from the finance charge if the specified conditions are met. Paragraph 4(d)(3) applies whether or not the debt cancellation agreement is considered to be insurance under state law. The language of paragraph 4(d)(3) has been modified in the final rule to clarify that it applies only to specific types of debt cancellation agreements.

Under the final rule, fees for GAP coverage must be disclosed according to paragraph 4(d)(3) rather than the provisions in paragraph 4(d)(2) for property insurance. Even though GAP coverage is triggered by the loss of or damage to property, GAP agreements do not insure against such loss or damage. Instead, GAP agreements typically cover the remaining balance due on the obligation *after* traditional property insurance benefits are exhausted.

Comments from credit insurance providers expressed concern that consumers will be unaware that debt cancellation agreements differ from credit insurance. According to these commenters, the differences are significant and stem largely from the fact that insurance is heavily regulated while, to date, debt cancellation agreements are largely unregulated. They also noted that debt cancellation coverage may require consumers to pay taxes that would not apply to credit insurance policies. The insurance providers believed that, in the past, the different treatment afforded to debt cancellation fees and credit insurance premiums under Regulation Z has protected consumers from the creditors' utilization of unregulated debt cancellation agreements, but that the new rule would promote their use. These commenters asserted that if the TILA cost disclosures are identical for insurance and non-insurance products, consumers will be misled or misinformed; they believe that even though greater consumer protection is afforded by the regulated insurance products, this difference will not be apparent to consumers.

The Board is mindful that debt cancellation agreements and traditional insurance products are not identical in all respects. From the consumer's standpoint, however, both products are available to satisfy the consumer's liability for the debt in full measure if the specified contingency occurs. The fact that debt cancellation agreements may be subject to less oversight by state regulators or different tax rules is not sufficient in the Board's judgment to suggest that the fees paid must necessarily be included in the finance charge and APR for purposes of the TILA's cost disclosures. Whatever degree of regulation may be appropriate for debt cancellation coverage, Regulation Z does not affect the ability of appropriate governmental authorities to implement such protections. The TILA cost disclosures are not intended to deter creditors from offering unregulated products.

While the TILA seeks to provide uniform disclosures about the cost and terms of credit to promote comparison shopping, the ultimate task of assessing the relative value of two different products that are similarly priced rests with the consumer. Where voluntary credit insurance and debt cancellation agreements cover the identical contingency for the same price, requiring the fee to be included in the finance charge and APR in one loan but not in the other does not fairly inform the borrower about the relative cost of the two loans. Consumers are unlikely to become better informed about the distinctions between these products simply by having the TILA disclosures make one loan appear costlier than the other. The new rule allows the cost to be excluded from the finance charge and APR in both cases, so long as the cost for the initial term of coverage is disclosed along with other specified items. Consumers are likely to find comparison shopping easier under this rule to the extent they will have similar cost disclosures for both products and will not have to account for different treatment in the finance charge or APR disclosures.

Likewise, consumers comparing loans offered by lenders in two different states will be able to comparison shop based on these cost disclosures without considering the impact state insurance laws might have on the disclosed finance charge or APR. Some commenters suggested that uniformity could be achieved just as easily if all voluntary debt cancellation fees were simply included in the finance charge rather than excluded. Uniformity would not be achieved by the adoption of such a rule, however, given that in states where debt cancellation coverage is considered insurance the statutory exclusion for credit insurance premiums would still allow creditors to exclude some debt cancellation fees from the finance charge.

The Board believes that treating debt cancellation fees and credit insurance premiums similarly for purposes of cost disclosure should not in itself create confusion about the nature of the parties' contractual relationship or the degree to which that relationship is regulated by state insurance agencies. The Board agrees that some confusion could result if creditors use the Board's existing model forms for disclosing insurance premiums to also disclose debt cancellation fees. Although the new rule allows both types of charges to be excluded from the finance charge under similar conditions, it does not authorize creditors to characterize debt cancellation fees as insurance premiums for TILA purposes. Creditors can comply with § 226.4(d)(3) by providing a disclosure that refers to debt cancellation coverage whether or not the agreement is considered insurance. Creditors may use the Board's existing credit insurance disclosure forms only if the debt cancellation coverage constitutes insurance under state law.

4(e) Certain Security-Interest Charges

4(e)(3) Taxes on Security Instruments

Paragraph 4(e)(3), which implements section 106(d)(3) of the TILA (15 U.S.C. 1605(d)(3)) is consistent with comment 4(e)–1(i) of the Official Staff Commentary. The new provision provides that taxes levied on security instruments or on documents evidencing indebtedness ("intangible property taxes"), that must be paid to record the security instrument, are excluded from the finance charge. The language has been modified slightly from the proposal, to clarify that the exclusion applies when payment of the tax is a requirement for recording the instrument, regardless of when the fee is paid.

Subpart C—Closed-end Credit

Section 226.17—General Disclosure Requirements

17(a) Form of Disclosures

17(a)(1)

Footnote 38 in paragraph 17(a)(1) is revised to include the disclosures relating to debt cancellation agreements among those that may be made together with or separately from the other required disclosures.

17(c) Basis of Disclosures and Use of Estimates

17(c)(2)

Paragraph 17(c)(2) is redesignated as 17(c)(2)(i) and modified slightly to reflect the general rule that disclosures must be based on the best information reasonably available to the creditor at the time the disclosures are provided to the consumer.

17(c)(2)(ii)

Paragraph 17(c)(2)(ii) reflects the 1995 amendment to section 121(c) of the TILA (15 U.S.C. 1631(c)), which deals with the disclosure of per-diem interest charges collected at loan consummation.

Per-diem interest, also known as "odd-days interest," is the interest that will accrue between consummation and the first regularly-scheduled payment. A disclosure affected by the amount of per-diem interest collected at consummation will be considered accurate if the disclosure is based on the information known to the creditor at the time the disclosure is prepared, even if the actual charge differs by the time disclosures are provided to the borrower. Creditors should exercise reasonable diligence in ascertaining the correct information when preparing disclosures.

Several commenters requested clarification on how the new $100 finance charge tolerance for mortgage loans applies when the per-diem interest charges disclosed prior to consummation are inaccurate. Under the new rule, if finance charge disclosures are affected by per-diem interest, creditors may rely on the charges known at the time the disclosures are prepared, and the disclosures will be deemed to be accurate without regard to the amount of per-diem charges actually paid at closing. In that case, the $100 finance charge tolerance would not be needed. If in the same transaction, other components of the finance charge were understated, the creditor would still have the benefit of the full $100 tolerance.

As commenters noted, this provision does not have any applicability in open-end credit transactions.

17(f) Early Disclosures

Paragraph 17(f) is revised to clarify the creditor's duty to provide new disclosures, which is determined by comparing the APR at the time of consummation to the APR disclosed earlier.

Section 226.18—Content of Disclosures

18(d) Finance Charge

Section 106(f) of the TILA (15 U.S.C. 1605(f)) establishes a new tolerance for accuracy in disclosing the finance charge for closed-end loans secured by real property or dwellings. Section 226.18(d) has been revised and reorganized to incorporate this change. Commenters generally supported the regulatory provisions implementing the new tolerances.

18(d)(1) Mortgage Loans

Paragraph 18(d)(1) provides a new finance charge tolerance applicable to mortgage loans consummated on or after September 30, 1995. For covered transactions, the disclosed finance charge will be considered accurate if it is understated by $100 or less or if the finance charge is overstated. The new tolerance applies to the disclosed finance charge as well as any disclosure affected by the finance charge, including the APR. The effect of the new finance charge tolerance on the disclosed APR is explained in more detail under paragraph 22(a).

Consumer groups expressed concern that the new statutory tolerance might be viewed as an opportunity for creditors to intentionally charge consumers up to $100 more than the finance charge stated in the TILA disclosures and they refer to the legislative history, which suggests that the new law was not intended to give lenders the right to pad fees. They argued that the new tolerances should apply, therefore, only to creditor errors made in good faith. Although this principle might appear sound, the Board notes that the existing tolerances in Regulation Z are not limited to good-faith errors and that application of a "good faith" rule would necessitate a case-by-case determination of how a particular error occurred, complicating the broad relief intended by the Congress. The Board believes that imposing a good-faith standard would be inconsistent with the purpose of the 1995 Amendments, which is to reduce potential litigation over disclosure errors. Moreover, with the new $100 tolerance, a creditor making intentional misstatements would leave little or no margin for making bona fide errors, risking the type of potential liability that led to enactment of the 1995 Amendments.

18(d)(2) Other Credit

The existing tolerance for finance charge disclosures, currently in footnote 41, continues to apply to all closed-end loans other than mortgage loans, and has been moved into paragraph 18(d)(2).

18(n) Insurance and Debt Cancellation Agreements

Paragraph 18(n) has been revised to include disclosures made in connection with debt cancellation agreements.

Section 226.19—Certain Residential Mortgage and Variable Rate Transactions

19(a)(2) Redisclosure Required

Paragraph 19(a)(2) has been further revised for clarity and consistency with paragraph 17(f).

Section 226.22—Determination of Annual Percentage Rate

22(a) Accuracy of Annual Percentage Rate

Paragraph 22(a) is revised to add new paragraphs (a)(4) and (a)(5). For closed-end loans secured by real property or dwellings, the new provisions establish two additional tolerances for accuracy in disclosing the APR when the disclosed finance charge is within the tolerances established by the 1995 Amendments.

The TILA contains tolerances for the APR, of either one-quarter or one-eighth of 1 percent, depending on the type of transaction. These existing statutory APR tolerances were not altered by the 1995 Amendments, although the amendments create a tolerance for the finance charge disclosed for mortgage loans as well as "any disclosure affected by the finance charge." Consumer groups argued that the Congress intended the new tolerances to apply only to numerical disclosures other than the APR (such as the "amount financed" and the "total of payments"), for which there is currently no regulatory or statutory tolerance. The Board believes, however, that the APR is one of the "affected disclosures." Otherwise, transactions in which the disclosed finance charge is misstated but considered accurate under the new tolerance would remain subject to legal challenge based on the disclosed APR, which seems inconsistent with the legislative intent. There was broad support for this approach among creditors who commented on the rule.

22(a)(4) Mortgage Loans

Paragraph 22(a)(4) provides an additional tolerance for APR disclosures in transactions where the finance charge is understated or overstated but is considered accurate under the 1995 Amendments. For example, in a secured home-improvement loan, if a creditor improperly omits a $100 fee from the

finance charge, the understated finance charge will now be considered accurate under § 226.18(d)(1). Under paragraph 22(a)(4), the APR resulting from the understated finance charge will also be considered accurate, even if the disclosed APR falls outside of the existing tolerance of one-eighth of 1 percent provided under section 107(c) of the TILA. For purposes of determining a borrower's right to rescind a mortgage loan, an APR resulting from a finance charge that is considered accurate in accordance with the applicable rule in § 226.23(g) or (h)(2) will also be considered accurate. The language has been modified slightly to clarify that new tolerances apply in addition to the existing tolerances in paragraphs 22(a)(2) and (3).

22(a)(5) Additional Tolerance for Mortgage Loans

In light of the new APR tolerance established under the 1995 Amendments, the Board has adopted an additional APR tolerance (not provided in the statute) in § 226.22(a)(5). The purpose is to avoid the anomalous result of imposing liability on a creditor for a disclosed APR that is incorrect but is *closer* to the actual APR than the APR that would be considered accurate under the statutory tolerance in paragraph 22(a)(4).

For instance, if the omission of a $100 fee from the finance charge results in an understatement of the finance charge and a disclosed APR that is understated by one-half of 1 percent, that APR will be considered accurate under paragraph 22(a)(4), even though it is outside of the existing APR tolerance of one-eighth of 1 percent. Under paragraph 22(a)(5), the disclosed APR is considered accurate if it is understated by *less* than one-half of 1 percent. Thus, if the actual APR in this example is 9.00 percent and the $100 omission results in an APR of 8.50 percent that is considered accurate under paragraph 22(a)(4), a disclosed APR of 8.75 percent will be within the tolerance in paragraph 22(a)(5). Similarly, if an overstated finance charge results in an overstated APR, the creditor will not be liable for an overstatement that is closer to the actual APR.

Under section 105 of the TILA, the Board is authorized to adopt exceptions to the TILA that will facilitate compliance. Paragraph 22(a)(5) treats as accurate, a disclosed APR that is more accurate than the one resulting from a misstated finance charge that is considered accurate under the 1995 Amendments. The Board believes that this rule will facilitate compliance with the TILA, and prevent disputes over errors that have no greater effect on consumers beyond the effects already contemplated by the statutory tolerances. The Board recognizes that this rule might allow a creditor to disclose an inaccurate APR that is not derived from either the actual or the disclosed finance charge. Presumably, this situation will not be common. On balance, however, the Board believes the rule is consistent with the intent of the 1995 Amendments.

The language in the proposed rule has been modified slightly to clarify that the new tolerance is in addition to and not in lieu of the existing tolerance.

Section 226.23—Right of Rescission

23(b) Notice of Right To Rescind

Paragraph 23(b)(2) clarifies that use of the appropriate model form approved by the Board, or a comparable form, is required for compliance with the regulation for those disclosures.

Model form H–9 was revised to ease compliance and to clarify that it may be used in loan refinancings with the original creditor, whether or not the creditor is the holder of the note at the time of refinancing. Some commenters requested further clarification on the proper use of the form, noting that it does not address the situation where the original note and mortgage are extinguished and new documents are executed to cover both the outstanding debt and the amount borrowed in the new transaction. The form has been revised in order to address these concerns.

23(g) Tolerances for Accuracy

Paragraph 23(g) implements section 106(f)(2) of the TILA (15 U.S.C. 1605(f)(2)). The Board is applying the rescission tolerances in section 106(f)(2) in addition to, rather than in lieu of, the general tolerances in section 106(f)(1). The Board believes this is consistent with the statutory language; it is unlikely that the Congress intended to allow the rescission remedy to be invoked when the disclosures would otherwise be considered accurate under the rules for civil and administrative liability. Most commenters supported these interpretations. Consumer groups expressed the view that the new rescission tolerances should only be applied to creditor errors made in good faith. For the reasons already discussed, the Board believes such an interpretation would be inconsistent with the legislative intent of the amendments.

Several commenters sought clarification of what constitutes a loan where "no new money is advanced" for purposes of § 226.23(g)(2). The rule has been modified for consistency and now refers to a refinancing in which there has been "no new advance." This phrase applies to loans for which the new amount financed does not exceed the unpaid principal balance plus any earned unpaid finance charge on the existing debt, and amounts attributed solely to the costs of the refinancing. This is consistent with section 226.23(f)(2) and the language used in comment 23(f)-4 of the Official Staff Commentary.

23(h) Special Rules for Foreclosures

Paragraph 23(h) implements section 125(i)(2) of the TILA (15 U.S.C. 1635(i)(2)), which provides special rescission rules after a foreclosure action has been initiated. Most commenters supported the proposal, although consumer groups believed that the foreclosure rules should apply to both open- and closed-end mortgage transactions.

The Board proposed to apply the new foreclosure rules only to closed-end mortgages since there appeared to be no basis for applying them to open-end lines of credit. The Board believes the Congress clearly intended to provide additional consumer protections once foreclosure has been initiated. For example, the statute allows a consumer to rescind a closed-end loan in foreclosure if the finance charge is understated by more than $35, even though a larger tolerance would otherwise apply. Because open-end home equity loans have *no* general tolerance for finance charge errors, applying the $35 tolerance to open-end loans in foreclosure would actually result in less protection for consumers. The Board believes this would be inconsistent with the intent of the special foreclosure rules. Accordingly, the Board interprets the foreclosure tolerances to apply only to closed-end loans.

The 1995 Amendments also allow a consumer to rescind a loan in foreclosure if a mortgage broker fee was not properly disclosed, without regard to the dollar amount involved. Consumer groups commented that this aspect of the new foreclosure rules should be applied to open-end transactions. Because broker fees are not generally associated with open-end lines of credit, it seems unlikely that this was the legislative intent. There is also no basis for reading this portion of the foreclosure rules more broadly than the foreclosure tolerances which apply only to closed-end transactions.

The new rules covering consumers' right to rescind a loan in foreclosure

only apply to transactions that were originally subject to the right of rescission. Consequently, the new rules do not apply to purchase money loans.

Subpart E—Special Rules for Certain Mortgage Transactions

Section 226.31—General Rules

31(d) Basis of Disclosures and Use of Estimates

Paragraph 31(d) is revised and reorganized, consistent with the revisions made to § 226.17(c).

31(d)(3)

Paragraph 31(d)(3) incorporates the new rule regarding the disclosure of per-diem interest charges, consistent with the amendment in section 226.17(c)(2)(ii). In preparing disclosures, creditors are expected to exercise reasonable diligence in ascertaining the necessary information. Paragraph 31(d)(3) has been modified slightly to clarify that the rule applies to a disclosure made pursuant to Subpart E (such as the APR) that would be affected by the per-diem interest charge.

31(g) Accuracy of Annual Percentage Rate

Paragraph 31(g) is intended to clarify that for purposes of determining whether a transaction is covered under § 226.32(a) and in making the disclosures required by § 226.32(c), a creditor may rely on its APR calculations if they are considered accurate according to the APR tolerances provided in § 226.22. For this purpose, the APR tolerances in paragraph 22(a) (4) and (5) apply only if the finance charge is considered accurate under § 226.18(d)(1); the rescission tolerances in § 226.23 (g) or (h) do not apply.

Consumer groups expressed the view that the new tolerances should not apply in determining whether a loan is covered under § 226.32(a). The language of the 1995 Amendments suggests that the new tolerances apply to all closed-end mortgage loans. The Board does not believe such an interpretation would be consistent with the legislative intent of the statute.

Appendix H to Part 226—Closed-End Model Forms and Clauses

H–9 Rescission Model Form

The 1995 Amendments clarify that creditors will not be liable for the form of rescission notice they give to the consumer if the creditor uses the appropriate form published by the Board or a comparable notice. In order to ease compliance, model form H–9 has been revised slightly to clarify that it may be used in loan refinancings with the original creditor, without regard to whether the original creditor is the holder of the note at the time of refinancing. Creditors may, however, continue to use the original forms H–8 and H–9 as appropriate.

Supplement I—Official Staff Interpretations

The revisions would conform the Official Staff Commentary consistent with the amendments to Regulation Z.

IV. Regulatory Flexibility Analysis

In accordance with section 3(a) of the Regulatory Flexibility Act (5 U.S.C. 603), the Board's Office of the Secretary has reviewed the amendments to Regulation Z. Overall, the amendments are not expected to have any significant impact on small entities. The regulatory revisions required to implement the 1995 Amendments clarify the existing disclosure requirements and ease compliance by providing new tolerances. Under the existing rules, fees charged in connection with debt cancellation agreements are generally treated as finance charges; the final rule allows creditors to exclude these fees from the finance charge if additional disclosures are provided to the consumer.

V. Paperwork Reduction Act

In accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3501 *et seq.*), the Board has reviewed the amendments to Regulation Z under the authority delegated to the Board by the Office of Management and Budget. 5 CFR part 1320 appendix A.1.

The respondents are individuals or businesses that regularly offer or extend consumer credit. The purpose of the TILA and Regulation Z is to promote the informed use of consumer credit by requiring creditors to disclose its terms and cost. Creditors must retain records of compliance for 24 months. The revisions to the requirements in this regulation are found in 12 CFR 226.4, 226.17, 226.18, 226.19, 226.23, and 226.31.

The disclosures made by creditors to consumers under Regulation Z are mandatory pursuant to the Truth in Lending Act (15 U.S.C. 1601 *et seq.*). Since the Federal Reserve does not collect any information, no issue of confidentiality under the Freedom of Information Act arises. Disclosures relating to specific transactions or accounts are not publicly available.

The Board's Regulation Z applies to all types of creditors, not just state member banks. Under the Paperwork Reduction Act, however, the Federal Reserve accounts for the paperwork burden associated with Regulation Z only for state member banks. Any estimates of paperwork burden for institutions other than state member banks that would be affected by the amendments would be provided by the federal agency or agencies that supervise those lenders.

There are 1,042 state member banks with an average frequency of 136,294 responses per bank each year. The current estimated burden for Regulation Z ranges from 5 seconds per response (for disclosures prior to opening a credit card account) to 30 minutes per response (for inclusion of information in an advertisement). The combined annual burden for all state member banks under Regulation Z is estimated to be 1,975,605 hours (an average of 1,896 hours per state member bank).

As stated in the notice of proposed rulemaking, the changes to the regulation are not expected to increase the ongoing annual burden of Regulation Z. The Federal Reserve also estimated the associated startup cost to be $160 per respondent for changing disclosures (or disclosure-producing software) to include disclosures relating to voluntary debt cancellation agreements.

The Federal Reserve received comments on the burden estimates from a multi-bank holding company and from a bank and its affiliated mortgage company. Both believed that the Federal Reserve's estimate of the cost of revising the disclosures was too low. However, some activities cited by the commenters, such as recordkeeping, filing, auditing, and monitoring, should be ongoing under the current rule. The burden for these activities is included in the figures above, estimated to be 1,896 hours per state member bank per year. Also, under the Paperwork Reduction Act, some activities, while associated with complying with the regulation, are not considered paperwork burden. Nonetheless, the Federal Reserve is revising its estimate of the typical startup cost at a state member bank to $3,000 to include the cost of additional legal services.

An agency may not collect or sponsor the collection or disclosure of information, and an organization is not required to collect or disclose information unless a currently valid OMB control number is displayed. The OMB control number for the Recordkeeping and Disclosure Requirements in Connection with Regulation Z is 7100–0199.

Send comments regarding the burden estimate, or any other aspect of this collection of information, including

suggestions for reducing the burden, to: Secretary, Board of Governors of the Federal Reserve System, 20th and C Streets, NW., Washington, DC 20551; and to the Office of Management and Budget, Paperwork Reduction Project (7100–0199), Washington, DC 20503.

List of Subjects in 12 CFR Part 226

Advertising, Banks, banking, Consumer protection, Credit, Federal Reserve System, Mortgages, Reporting and recordkeeping requirements, Truth in lending.

For the reasons set forth in the preamble, the Board amends 12 CFR Part 226 as follows:

PART 226—TRUTH IN LENDING (REGULATION Z)

1. The authority citation for part 226 continues to read as follows:

Authority: 12 U.S.C. 3806; 15 U.S.C. 1604 and 1637(c)(5).

2. Section 226.2 is amended by revising paragraph (a)(6) to read as follows:

§ 226.2 Definitions and rules of construction.

(a) *Definitions.* * * *

* * * * *

(6) *Business day* means a day on which the creditor's offices are open to the public for carrying on substantially all of its business functions. However, for purposes of rescission under §§ 226.15 and 226.23, and for purposes of § 226.31, the term means all calendar days except Sundays and the legal public holidays specified in 5 U.S.C. 6103(a), such as New Year's Day, the Birthday of Martin Luther King, Jr., Washington's Birthday, Memorial Day, Independence Day, Labor Day, Columbus Day, Veterans Day, Thanksgiving Day, and Christmas Day.

* * * * *

3. Section 226.4 is amended as follows:

a. Paragraph (a) is revised;

b. New paragraph (b)(10) is added;

c. A heading is added to paragraph (c)(7), the introductory text to paragraph (c)(7) is republished, paragraphs (c)(7)(ii) and (c)(7)(iii) are revised, paragraph (c)(7)(iv) is redesignated as paragraph (c)(7)(v) and republished, and a new paragraph (c)(7)(iv) is added;

d. The paragraph (d) heading is revised, the paragraph (d)(1) heading and introductory text are revised, paragraph (d)(1)(i) is revised, and a new paragraph (d)(3) is added.

e. A new paragraph (e)(3) is added.

The revisions and additions are to read as follows:

§ 226.4 Finance charge.

(a) *Definition.* The finance charge is the cost of consumer credit as a dollar amount. It includes any charge payable directly or indirectly by the consumer and imposed directly or indirectly by the creditor as an incident to or a condition of the extension of credit. It does not include any charge of a type payable in a comparable cash transaction.

(1) *Charges by third parties.* The finance charge includes fees and amounts charged by someone other than the creditor, unless otherwise excluded under this section, if the creditor:

(i) requires the use of a third party as a condition of or an incident to the extension of credit, even if the consumer can choose the third party; or

(ii) retains a portion of the third-party charge, to the extent of the portion retained.

(2) *Special rule; closing agent charges.* Fees charged by a third party that conducts the loan closing (such as a settlement agent, attorney, or escrow or title company) are finance charges only if the creditor:

(i) Requires the particular services for which the consumer is charged;

(ii) Requires the imposition of the charge; or

(iii) Retains a portion of the third-party charge, to the extent of the portion retained.

(3) *Special rule; mortgage broker fees.* Fees charged by a mortgage broker (including fees paid by the consumer directly to the broker or to the creditor for delivery to the broker) are finance charges even if the creditor does not require the consumer to use a mortgage broker and even if the creditor does not retain any portion of the charge.

(b) *Example of finance charge* * * *

* * * * *

(10) *Debt cancellation fees.* Charges or premiums paid for debt cancellation coverage written in connection with a credit transaction, whether or not the debt cancellation coverage is insurance under applicable law.

(c) *Charges excluded from the finance charge.* * * *

* * * * *

(7) *Real-estate related fees.* The following fees in a transaction secured by real property or in a residential mortgage transaction, if the fees are bona fide and reasonable in amount:

* * * * *

(ii) Fees for preparing loan-related documents, such as deeds, mortgages, and reconveyance or settlement documents.

(iii) Notary and credit report fees.

(iv) Property appraisal fees or fees for inspections to assess the value or condition of the property if the service is performed prior to closing, including fees related to pest infestation or flood hazard determinations.

(v) Amounts required to be paid into escrow or trustee accounts if the amounts would not otherwise be included in the finance charge.

* * * * *

(d) *Insurance and debt cancellation coverage.*—(1) *Voluntary credit insurance premiums.* Premiums for credit life, accident, health or loss-of-income insurance may be excluded from the finance charge if the following conditions are met:

(i) The insurance coverage is not required by the creditor, and this fact is disclosed in writing.

* * * * *

(3) *Voluntary debt cancellation fees.* (i) Charges or premiums paid for debt cancellation coverage of the type specified in paragraph (d)(3)(ii) of this section may be excluded from the finance charge, whether or not the coverage is insurance, if the following conditions are met:

(A) The debt cancellation agreement or coverage is not required by the creditor, and this fact is disclosed in writing;

(B) The fee or premium for the initial term of coverage is disclosed. If the term of coverage is less than the term of the credit transaction, the term of coverage also shall be disclosed. The fee or premium may be disclosed on a unit-cost basis only in open-end credit transactions, closed-end credit transactions by mail or telephone under § 226.17(g), and certain closed-end credit transactions involving a debt cancellation agreement that limits the total amount of indebtedness subject to coverage;

(C) The consumer signs or initials an affirmative written request for coverage after receiving the disclosures specified in this paragraph. Any consumer in the transaction may sign or initial the request.

(ii) Paragraph (d)(3)(i) of this section applies to fees paid for debt cancellation coverage that provides for cancellation of all or part of the debtor's liability for amounts exceeding the value of the collateral securing the obligation, or in the event of the loss of life, health, or income or in case of accident.

(e) *Certain security interest charges.* * * *

* * * * *

(3) *Taxes on security instruments.* Any tax levied on security instruments or on documents evidencing indebtedness if the payment of such taxes is a requirement for recording the

instrument securing the evidence of indebtedness.

* * * * *

4. Section 226.17 is amended as follows:

a. In paragraph (a)(1), footnote 38 is revised;

b. Paragraph (c)(2) is redesignated as paragraph (c)(2)(i) and revised, and paragraph (c)(2)(ii) is added;

c. Paragraph (f) is revised.

The revisions and additions are to read as follows:

§ 226.17 General disclosure requirements.

(a) *Form of disclosures.* (1) * * *[38] * * *

* * * * *

(c) *Basis of disclosures and use of estimates.* * * *

(2)(i) If any information necessary for an accurate disclosure is unknown to the creditor, the creditor shall make the disclosure based on the best information reasonably available at the time the disclosure is provided to the consumer, and shall state clearly that the disclosure is an estimate.

(ii) For a transaction in which a portion of the interest is determined on a per-diem basis and collected at consummation, any disclosure affected by the per-diem interest shall be considered accurate if the disclosure is based on the information known to the creditor at the time that the disclosure documents are prepared for consummation of the transaction.

* * * * *

(f) *Early disclosures.* If disclosures required by this subpart are given before the date of consummation of a transaction and a subsequent event makes them inaccurate, the creditor shall disclose before consummation:[39]

(1) any changed term unless the term was based on an estimate in accordance with § 226.17(c)(2) and was labelled an estimate;

(2) all changed terms, if the annual percentage rate at the time of consummation varies from the annual percentage rate disclosed earlier by more than ⅛ of 1 percentage point in a regular transaction, or more than ¼ of 1 percentage point in an irregular transaction, as defined in § 226.22(a).

* * * * *

5. Section 226.18 is amended as follows:

a. Footnote 41 in paragraph (d) is removed and paragraph (d) introductory text is republished;

b. New paragraphs (d)(1) and (d)(2) are added;

c. Footnotes 39 and 40 in paragraph (c) are redesignated as footnotes 40 and 41 respectively; and

d. Paragraph (n) is revised.

The revisions and additions are to read as follows:

§ 226.18 Content of disclosures.

* * * * *

(d) *Finance charge.* The *finance charge,* using that term, and a brief description such as "the dollar amount the credit will cost you."

(1) *Mortgage loans.* In a transaction secured by real property or a dwelling, the disclosed finance charge and other disclosures affected by the disclosed finance charge (including the amount financed and the annual percentage rate) shall be treated as accurate if the amount disclosed as the finance charge:

(i) is understated by no more than $100; or

(ii) is greater than the amount required to be disclosed.

(2) *Other credit.* In any other transaction, the amount disclosed as the finance charge shall be treated as accurate if, in a transaction involving an amount financed of $1,000 or less, it is not more than $5 above or below the amount required to be disclosed; or, in a transaction involving an amount financed of more than $1,000, it is not more than $10 above or below the amount required to be disclosed.

* * * * *

(n) *Insurance and debt cancellation.* The items required by § 226.4(d) in order to exclude certain insurance premiums and debt cancellation fees from the finance charge.

* * * * *

6. Section 226.19 is amended by revising paragraph (a)(2) to read as follows:

§ 226.19 Certain residential mortgage and variable-rate transactions.

(a) * * *

(2) *Redisclosure required.* If the annual percentage rate at the time of consummation varies from the annual percentage rate disclosed earlier by more than ⅛ of 1 percentage point in a regular transaction or more than ¼ of 1 percentage point in an irregular transaction, as defined in § 226.22, the creditor shall disclose all the changed terms no later than consummation or settlement.

* * * * *

7. Section 226.22 is amended by adding new paragraphs (a)(4) and (a)(5) to read as follows:

§ 226.22 Determination of annual percentage rate.

(a) *Accuracy of annual percentage rate.* * * *

* * * * *

(4) *Mortgage loans.* If the annual percentage rate disclosed in a transaction secured by real property or a dwelling varies from the actual rate determined in accordance with paragraph (a)(1) of this section, in addition to the tolerances applicable under paragraphs (a)(2) and (3) of this section, the disclosed annual percentage rate shall also be considered accurate if:

(i) The rate results from the disclosed finance charge; and

(ii)(A) The disclosed finance charge would be considered accurate under § 226.18(d)(1); or

(B) For purposes of rescission, if the disclosed finance charge would be considered accurate under § 226.23(g) or (h), whichever applies.

(5) *Additional tolerance for mortgage loans.* In a transaction secured by real property or a dwelling, in addition to the tolerances applicable under paragraphs (a)(2) and (3) of this section, if the disclosed finance charge is calculated incorrectly but is considered accurate under § 226.18(d)(1) or § 226.23(g) or (h), the disclosed annual percentage rate shall be considered accurate:

(i) If the disclosed finance charge is understated, and the disclosed annual percentage rate is also understated but it is closer to the actual annual percentage rate than the rate that would be considered accurate under paragraph (a)(4) of this section;

(ii) If the disclosed finance charge is overstated, and the disclosed annual percentage rate is also overstated but it is closer to the actual annual percentage rate than the rate that would be considered accurate under paragraph (a)(4) of this section.

* * * * *

8. Section 226.23 is amended as follows:

a. Paragraphs (b)(1) through (b)(5) are redesignated as paragraphs (b)(1)(i) through (b)(1)(v);

b. The introductory text of paragraph (b) is redesignated as (b)(1) and republished;

c. A new paragraph (b)(2) is added; and

d. New paragraphs (g) and (h) are added.

The revisions and additions are to read as follows:

---

[38] The following disclosures may be made together with or separately from other required disclosures: the creditor's identity under § 226.18(a), the variable rate example under § 226.18(f)(4), insurance or debt cancellation under § 226.18(n), and certain security interest charges under § 226.18(o).

[39] For certain residential mortgage transactions, § 226.19(a)(2) permits redisclosure no later than consummation or settlement, whichever is later.

§ 226.23 Right of rescission.

* * * * *

(b)(1) *Notice of right to rescind.* In a transaction subject to rescission, a creditor shall deliver two copies of the notice of the right to rescind to each consumer entitled to rescind. The notice shall be on a separate document that identifies the transaction and shall clearly and conspicuously disclose the following:

(i) The retention or acquisition of a security interest in the consumer's principal dwelling.

(ii) The consumer's right to rescind the transaction.

(iii) How to exercise the right to rescind, with a form for that purpose, designating the address of the creditor's place of business.

(iv) The effects of rescission, as described in paragraph (d) of this section.

(v) The date the rescission period expires.

(2) *Proper form of notice.* To satisfy the disclosure requirements of paragraph (b)(1) of this section, the creditor shall provide the appropriate model form in Appendix H of this part or a substantially similar notice.

* * * * *

(g) *Tolerances for accuracy.*—(1) *One-half of 1 percent tolerance.* Except as provided in paragraphs (g)(2) and (h)(2) of this section, the finance charge and other disclosures affected by the finance charge (such as the amount financed and the annual percentage rate) shall be considered accurate for purposes of this section if the disclosed finance charge:

(i) is understated by no more than ½ of 1 percent of the face amount of the note or $100, whichever is greater; or

(ii) is greater than the amount required to be disclosed.

(2) *One percent tolerance.* In a refinancing of a residential mortgage transaction with a new creditor (other than a transaction covered by § 226.32), if there is no new advance and no consolidation of existing loans, the finance charge and other disclosures affected by the finance charge (such as the amount financed and the annual percentage rate) shall be considered accurate for purposes of this section if the disclosed finance charge:

(i) is understated by no more than 1 percent of the face amount of the note or $100, whichever is greater; or

(ii) is greater than the amount required to be disclosed.

(h) *Special rules for foreclosures.*—(1) *Right to rescind.* After the initiation of foreclosure on the consumer's principal dwelling that secures the credit obligation, the consumer shall have the right to rescind the transaction if:

(i) A mortgage broker fee that should have been included in the finance charge was not included; or

(ii) The creditor did not provide the properly completed appropriate model form in Appendix H of this part, or a substantially similar notice of rescission.

(2) *Tolerance for disclosures.* After the initiation of foreclosure on the consumer's principal dwelling that secures the credit obligation, the finance charge and other disclosures affected by the finance charge (such as the amount financed and the annual percentage rate) shall be considered accurate for purposes of this section if the disclosed finance charge:

(i) is understated by no more than $35; or

(ii) is greater than the amount required to be disclosed.

9. Section 226.31 is amended by revising paragraphs (d) and (g) to read as follows:

§ 226.31 General rules.

* * * * *

(d) *Basis of disclosures and use of estimates*—(1) *Legal Obligation.* Disclosures shall reflect the terms of the legal obligation between the parties.

(2) *Estimates.* If any information necessary for an accurate disclosure is unknown to the creditor, the creditor shall make the disclosure based on the best information reasonably available at the time the disclosure is provided, and shall state clearly that the disclosure is an estimate.

(3) *Per-diem interest.* For a transaction in which a portion of the interest is determined on a per-diem basis and collected at consummation, any disclosure affected by the per-diem interest shall be considered accurate if the disclosure is based on the information known to the creditor at the time that the disclosure documents are prepared.

* * * * *

(g) *Accuracy of annual percentage rate.* For purposes of § 226.32, the annual percentage rate shall be considered accurate, and may be used in determining whether a transaction is covered by § 226.32, if it is accurate according to the requirements and within the tolerances under § 226.22. The finance charge tolerances for rescission under § 226.23(g) or (h) shall not apply for this purpose.

10. In Part 226, Appendix H is amended by revising the H–9 Rescission Model Form and the contents listing at the beginning of Appendix H to read as follows:

Appendix H to Part 226—Closed End Model Forms and Clauses

* * * * *

H–9—Rescission Model Form (Refinancing with Original Creditor)

NOTICE OF RIGHT TO CANCEL

Your Right to Cancel

You are entering into a new transaction to increase the amount of credit previously provided to you. Your home is the security for this new transaction. You have a legal right under federal law to cancel this new transaction, without cost, within three business days from whichever of the following events occurs last:

(1) the date of this new transaction, which is _____; or

(2) the date you received your new Truth in Lending disclosures; or

(3) the date you received this notice of your right to cancel.

If you cancel this new transaction, it will not affect any amount that you presently owe. Your home is the security for that amount. Within 20 calendar days after we receive your notice of cancellation of this new transaction, we must take the steps necessary to reflect the fact that your home does not secure the increase of credit. We must also return any money you have given to us or anyone else in connection with this new transaction.

You may keep any money we have given you in this new transaction until we have done the things mentioned above, but you must then offer to return the money at the address below.

If we do not take possession of the money within 20 calendar days of your offer, you may keep it without further obligation.

How To Cancel

If you decide to cancel this new transaction, you may do so by notifying us in writing, at

_____

(Creditor's name and business address).

You may use any written statement that is signed and dated by you and states your intention to cancel, or you may use this notice by dating and signing below. Keep one copy of this notice because it contains important information about your rights.

If you cancel by mail or telegram, you must send the notice no later than midnight of

_____

(Date) _____

(or midnight of the third business day following the latest of the three events listed above).

If you send or deliver your written notice to cancel some other way, it must be delivered to the above address no later than that time.

I WISH TO CANCEL

_____

Consumer's Signature

_____

Date

11. In Supplement I to Part 226, under *Section 226.4—Finance Charge*, under *4(a) Definition*, paragraph 3.ii. is removed.

12. In Supplement I to Part 226, under *Section 226.17—General Disclosure Requirements*, under *17(c) Basis of disclosures and use of estimates*, paragraph 17(c)(2) is redesignated as paragraph 17(c)(2)(i):

Supplement I—Official Staff Interpretations

* * * * *

Section 226.17—General Disclosure Requirements

* * * * *

17(c) Basis of Disclosures and Use of Estimates

* * * * *

Paragraph 17(c)(2)(i).

* * * * *

13. In Supplement I to Part 226, under *Section 226.18—Content of Disclosures*, under *18(d) Finance charge*, paragraph 2 is removed.

14. In Supplement I to Part 226, under *Section 226.23—Right of Rescission*, under *23(b) Notice of right to rescind*, the first sentence of paragraph 3 is revised to read as follows:

Section 226.23—Right of Rescission.

* * * * *

23(b) Notice of right to rescind

* * * * *

3. *Content.* The notice must include all of the information outlined in Section 226.23(b)(1)(i) through (v). * * *

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By order of the Board of Governors of the Federal Reserve System, September 13, 1996.

William W. Wiles,

Secretary of the Board.

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