

**FEDERAL RESERVE BANK
OF NEW YORK**

[Circular No. 10825]
January 10, 1996

TRUTH IN LENDING

**Proposed Amendments to Regulation Z Regarding the Use
of Finance Charges to Reflect the Cost of Consumer Credit**

Comments Invited by February 9

*To All Depository Institutions, and Others Concerned,
in the Second Federal Reserve District:*

The following statement has been issued by the Board of Governors of the Federal Reserve System:

The Federal Reserve Board has requested comment concerning the use of finance charges to accurately reflect the cost of consumer credit. Comment is requested by February 9, 1996.

Truth in Lending Act Amendments of 1995 direct the Board to submit a report to Congress, in early spring 1996, regarding this issue. However, charges payable in a comparable cash transaction will continue to be excluded from the finance charge and from public comment.

In the report, the Board must consider, and requests comment on, the feasibility of including in the finance charge all charges payable directly or indirectly by the consumer and imposed directly or indirectly by the creditor as an incident to the credit transaction — especially costs associated with real estate- or home-secured lending that are currently excluded from the finance charge under section 106 of the Truth in Lending Act. The report must also address abusive refinancing practices engaged in by a creditor for the purpose of avoiding a consumer's rescission rights.

Printed on the following pages is the text of the proposal, which has been published in the *Federal Register*. Comments thereon should be submitted by February 9, and may be sent to the Board of Governors, as specified in the Board's notice, or to our Compliance Examinations Department.

WILLIAM J. McDONOUGH,
President.

of avoiding a consumer's rescission rights.

DATES: Comments must be received on or before February 9, 1996.

ADDRESSES: Comments should refer to Docket No. R-0908, and may be mailed to William W. Wiles, Secretary of the Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551. Comments also may be delivered to Room B-2222 of the Eccles Building between 8:45 a.m. and 5:15 p.m. weekdays, or to the guard station in the Eccles Building courtyard on 20th Street, NW., (between Constitution Avenue and C Street) at any time. Comments may be inspected in Room MP-500 of the Martin Building between 9 a.m. and 5 p.m. weekdays, except as provided in 12 CFR 261.8 of the Board's rules regarding the availability of information.

FOR FURTHER INFORMATION CONTACT: Jane E. Ahrens, Senior Attorney, or Sheilah Goodman, or Kurt Schumacher, Staff Attorneys, Division of Consumer and Community Affairs, Board of Governors of the Federal Reserve System, at (202) 452-3667 or 452-2412. For users of Telecommunications Devices for the Deaf, contact Dorothea Thompson, at (202) 452-3544.

SUPPLEMENTARY INFORMATION:

I. Background

The Truth in Lending Act Amendments of 1995 (1995 Amendments Act), Pub. L. 104-29, 109 Stat. 271, enacted into law on September 30, 1995, direct the Board to submit a report to the Congress concerning the use of finance charges to accurately reflect the cost of consumer credit. The Board must consider the feasibility of including in the finance charge all charges payable directly or indirectly by the consumer and imposed directly or indirectly by the creditor as an incident to the credit transaction—especially costs associated with real estate- or home-secured lending that are currently excluded from the finance charge under section 106 of the Truth in Lending Act. As contemplated by the Congress, perhaps only charges payable in a comparable cash transaction would continue to be excluded from the finance charge. The report must also address abusive refinancing practices engaged in by a creditor for the purpose of avoiding a consumer's rescission rights. The Board will submit its report to the Congress in early spring 1996, based on the comments of interested parties and on its own analysis.

FEDERAL RESERVE SYSTEM

12 CFR Part 226

[Reg. Z; Docket No. R-0908]

Truth in Lending

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Request for comments.

SUMMARY: The Board is soliciting comment on how the finance charge could more accurately reflect the cost of consumer credit. In particular, the Board is asking for the public's views on the feasibility of treating as finance charges all costs imposed by the creditor or payable by the consumer as an incident to the extension of credit. The Truth in Lending Act Amendments of 1995 direct the Board to submit a report to the Congress regarding these issues. Under present law, costs such as interest are part of the finance charge; other costs, including many associated with real estate-secured lending, are excluded from the finance charge. The Board is also required to address in its report abusive refinancing practices engaged in by creditors for the purpose

II. Finance Charges

Definition

The Truth in Lending Act (15 U.S.C. 1601 et seq.) contains rules governing the disclosure of finance charges (Section 106). The act is implemented by the Board's Regulation Z (12 CFR part 226). Rules on finance charges are contained in Regulation Z § 226.4 and accompanying official staff interpretations. The finance charge is defined as the cost of consumer credit expressed 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. The term "imposed" is interpreted broadly, to include any cost charged by the creditor (unless otherwise excluded), including charges for optional services paid by the consumer. Examples of a finance charge include interest, points, and service or transaction fees.

The act excludes certain costs from the finance charge, such as charges payable in a comparable cash transaction and fees paid to third-party closing agents (unless the creditor requires the services provided or retains the fee). Many costs associated with loans secured by real estate or a principal dwelling are specifically excluded; examples are fees for appraisals, document preparation, title insurance, and pest inspections prior to loan closing. The regulation also excludes charges such as application fees (charged to all applicants), late payment fees, and most taxes.

Still other costs that are generally included in the finance charge may nevertheless be excluded. For example, the act provides that credit report fees are finance charges, but provides an exception for credit report fees associated with real estate- or home-secured loans. The act also excludes optional credit life insurance premiums and fees to record a security interest if the cost is disclosed to the consumer and meets other conditions.

Annual percentage rate

In addition to requiring disclosure of finance charges as a dollar amount, the act and regulation require creditors to disclose the cost of consumer credit as an annual percentage rate (APR). Creditors must disclose an APR for all types of consumer credit—installment loans (closed-end credit) and credit card accounts or home equity lines of credit (open-end plans). The APR for closed-end credit and open-end plans reflect finance charges, but the distinct nature

of these products calls for differences in how the APR is calculated.

The APR for closed-end credit is based on the amounts borrowed by the consumer in relation to the amount and timing of payments to the creditor. It factors in interest and all other finance charges. Costs such as recording fees or title insurance fees may be disclosed, but are not a part of the finance charge and thus, are excluded from the APR calculation.

Under open-end plans such as a home equity line of credit, the creditor typically sets the maximum amount that can be borrowed at any time. The amount that will actually be borrowed by the consumer, however, is typically unknown when the credit plan is established. The APR stated in advertisements and account-opening disclosures reflects only the rate of interest that will be applied to any outstanding balance the consumer may have in the future. Additional costs—whether finance or other charges—are separately identified.

Consumers with outstanding balances receive an APR on periodic statements. That APR is based on the outstanding balance and certain finance charges imposed during the cycle. Some finance charges, such as points charged in connection with establishing a home equity plan or other fees to open or renew plans, would skew the APR for the billing cycle in which they are imposed. These types of finance charges are disclosed on periodic statements but are not figured in the APR.

Request for Comment

The Board requests comments on how the definition of the finance charge could be modified, if at all, to reflect the cost of consumer credit more accurately. The Congress directs the Board to make recommendations on any necessary statutory and regulatory changes. (1995 Amendments, Section 2(f).) The Board believes the scope of the study is limited to possible modifications to the definition of the finance charge.

The 1995 Amendments contain, for the most part, provisions affecting closed-end credit that is real estate- or home-secured. The Board believes that the scope of the report is intended to cover the treatment of costs as finance charges for *all* types of consumer credit, although a focus of the study will be on those fees associated with real estate lending that are currently excluded from the finance charge. For example, many costs associated with entering into home-secured loans are the same whether the credit is an installment loan or a line of credit. Similarly, certain application fees are excluded from the

finance charge for all types of credit transactions, not just those affecting installment loans.

Comment is requested on the feasibility of including in the finance charge all charges payable directly or indirectly by the consumer and imposed directly or indirectly by the creditor as an incident to the credit transaction (other than costs imposed in comparable cash transactions), particularly costs associated with real estate- or home-secured credit that are currently excluded from the finance charge. For example, mortgage brokers fees are sometimes, but not always, a finance charge under present law: A new statutory provision categorizes all brokers fees paid by the consumer to the broker (or to the creditor for delivery to the broker) as finance charges, and will go into effect when the Board issues a final rule in 1996.

In assessing the feasibility of this approach, the Board must consider the implications of including charges imposed by third parties—settlement agents and others—that may not be within the creditor's knowledge or control. Comment is requested on compliance issues that would arise if the definition of the finance charge were expanded to include charges by third parties.

Treating all costs as a finance charge would, of course, simplify creditor compliance with the TILA and Regulation Z; it would reduce the potential for disclosure errors. The Board believes the study is, in part, a reaction to the spate of class action lawsuits that followed the court decision of *Rodash v. AIB Mortgage Company*. (16 F.3d 1142 (11th Cir. 1994)). In *Rodash*, the court found, among other TILA violations, that the creditor improperly excluded several fees from the finance charge calculation—totalling about \$225. The court awarded civil money damages and allowed the consumer to rescind a \$100,000 loan.

Including all costs in the finance charge, however, would also increase the APR disclosed for closed-end credit transactions—dramatically, in some cases. For example, the APR for home-secured loans would reflect closing costs such as appraisal fees, title insurance and the like. Including premiums for optional credit life insurance or for property insurance in the finance charge could also have a significant impact on the APR. The resulting APR for installment loans may seem distorted, particularly in relation to the APR disclosed for a comparable open-end product. For example, disclosures for a home-secured open-

end plan would include closing costs and insurance premiums as finance charges, but those fees would not be included in the APR stated in advertisements or account-opening disclosures, unless the current rules on calculating the APR are changed.

III. Abusive Refinancing Practices

The act and regulation allow consumers to cancel (or rescind) certain credit transactions secured by the consumer's principal dwelling. For example, the right of rescission applies if a consumer's principal dwelling is used to secure a loan financing home improvements or a child's education. Other loans secured by a consumer's principal dwelling are not rescindable, such as a loan for a business purpose.

A consumer's right to rescind a refinanced loan depends on both the creditor and amount of money involved. If the creditor refinancing the loan is the same creditor that initially extended the credit, consumers may rescind the refinancing only to the extent new monies are advanced. For example, if a consumer's principal dwelling secures a loan with a creditor and the consumer seeks to refinance an outstanding balance of \$100,000 with the same creditor, the transaction is not rescindable. If the consumer obtains \$25,000 in an additional advance, the refinancing could be rescinded up to the new advance of \$25,000. If the consumer refinances the loan with a new creditor instead, the entire transaction is rescindable, whether or not new monies are advanced.

The Board's report must include recommendations, if any, for statutory or regulatory changes necessary to address abusive refinancing practices engaged in by a creditor for the purpose of avoiding a consumer's rescission rights. Comment is requested on the issue.

IV. Form of Comment Letters

Comment letters should refer to Docket No. R-0908, and, when possible, should use a standard courier typeface with a type size of 10 or 12 characters per inch. This will enable the Board to convert the text to machine-readable form through electronic scanning, and will facilitate automated retrieval of comments for review. Also, if accompanied by an original document in paper form, comments may be submitted on 3½ inch or 5¼ inch computer diskettes in any IBM-compatible DOS-based format.

By order of the Board of Governors of the Federal Reserve System, December 15, 1995.

William W. Wiles,
Secretary of the Board.

[FR Doc. 95-30994 Filed 12-20-95; 8:45 am]

BILLING CODE 6210-01-P