RESCINDED

Office of Thrift Supervision **January 29, 2004**

Department of the Treasury

Regulatory Bulletin

RB 36-1

Regulatory Bulletin 36-1 is no longer needed. Any attachments to this document are rescinded only as they relate to national banks and federal savings associations.

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Compliance Activities Handbook Update

Summary: This is the fourth update to the Compliance Activities Handbook. It includes revisions to Sections 305, 323, 325 and 360, Truth in Lending, Homeowner Protection Act, Consumer Leasing and Homeownership Counseling, respectively.

For Further Information Contact: Your Office of Thrift Supervision (OTS) Regional Office or the Compliance Policy Division of the OTS, Washington, DC. You may access this bulletin at our website: www.ots.treas.gov

Regulatory Bulletin 36-1

Summary of Changes

OTS is issuing updates to the following Compliance Activities Handbook Sections. We provide a summary of changes below.

Section	**300**	**Consumer Laws and Regulations**
	305	**Truth in Lending:** This revised section includes several modifications primarily related to recent regulatory changes in the implementation of the Home Ownership and Equity Protection Act pertaining to certain high cost mortgages, including worksheets for analysis of such lending.
	323	**Homeowner Protection Act:** This section has been updated to conform to recent technical amendments made to the law, including defining original value, clarifying amortization of adjustable rate mortgages, providing a measure for good payment history and designating loans with balloon payments for treatment as adjustable rate mortgages.
	325	**Consumer Leasing:** This section has been reformatted to present the material in clearer terms and to include key definitions.
	360	**Homeownership Counseling:** This section has been updated to recognize the elimination of past statutory sunset provisions. In addition, current supervisory review has been limited to requirements involving delinquent borrowers pending further guidance from HUD on the applicability of first-time homebuyer requirements.

Instructions on Updating the Compliance Activities Handbook
January 2004

Discard	**Insert**
Section 305 (all pages)	Section 305 (January 2004)
Section 323 (all pages)	Section 323 (January 2004)
Section 325 (all pages)	Section 325 (January 2004)
Section 360 (all pages)	Section 360 (January 2004)

—Scott M. Albinson
Managing Director, Supervision

Introduction

Background and Summary

The Truth in Lending Act (TILA), 15 USC 1601 et seq., was enacted on May 29, 1968, as title I of the Consumer Credit Protection Act (Pub. L. 90-321). The TILA, implemented by Regulation Z (12 CFR 226), became effective July 1, 1969.

The TILA was first amended in 1970 to prohibit unsolicited credit cards. Additional major amendments to the TILA and Regulation Z were made by the Fair Credit Billing Act of 1974, the Consumer Leasing Act of 1976, the Truth in Lending Simplification and Reform Act of 1980, the Fair Credit and Charge Card Disclosure Act of 1988, and the Home Equity Loan Consumer Protection Act of 1988.

Regulation Z also was amended to implement section 1204 of the Competitive Equality Banking Act of 1987 and, in 1988, to include adjustable rate mortgage loan disclosure requirements. All consumer leasing provisions were deleted from Regulation Z in 1981 and transferred to Regulation M (12 CFR 213).

The Home Ownership and Equity Protection Act of 1994 amended TILA. The law imposed new disclosure requirements and substantive limitations on certain closed-end mortgage loans bearing rates or fees above a certain percentage or amount. The law also included new disclosure requirements to assist consumers in comparing the costs and other material considerations involved in a reverse mortgage transaction and authorized the Federal Reserve Board to prohibit specific acts and practices in connection with mortgage transactions. Regulation Z was amended[1] to implement these legislative changes to TILA.

Approved – FFIEC

The TILA amendments of 1995 dealt primarily with tolerances for real estate secured credit. Regulation Z was amended on September 14, 1996 to incorporate changes to the TILA. Specifically, the revisions limit lenders' liability for disclosure errors in real estate secured loans consummated after September 30, 1995. The Economic Growth and Regulatory Paperwork Reduction Act of 1996 further amended TILA. The amendments were made to simplify and improve disclosures related to credit transactions.

Format of Regulation Z

The disclosure rules creditors must follow differ depending on whether the creditor is offering open-end credit, such as credit cards or home-equity lines, or closed-end credit, such as car loans or mortgages.

Subpart A (sections 226.1 through 226.4) of the regulation provides general information that applies to open-end and closed-end credit transactions. It sets forth definitions and stipulates which transactions are covered and which are exempt from the regulation. It also contains the rules for determining which fees are finance charges.

Subpart B (sections 226.5 through 226.16) of the regulation contains rules for disclosures for home-equity loans, credit and charge card accounts, and other open-end credit.

Subpart B also covers rules for resolving billing errors, calculating annual percentage rates, credit balances, and advertising open-end credit. Special rules apply to credit card transactions only, such as certain prohibitions on the issuance of credit cards and restrictions on the right to offset a cardholder's indebtedness. Additional special rules apply to home-equity lines of credit, such as certain prohibitions against closing accounts or changing account terms.

[1] 60 FR 15463, March 24, 1995 and 66 FR 65604, December 20, 2001.

Subpart C (sections 226.17 through 226.24) includes provisions for closed-end credit. Residential mortgage transactions, demand loans, and installment credit contracts, including direct loans by banks and purchased dealer paper, are included in the closed-end credit category. Subpart C also contains disclosure rules for regular and variable rate loans, refinancings and assumptions, credit balances, calculating annual percentage rates, and advertising closed-end credit.

Subpart D (sections 226.25 through 226.30), which applies to both open-end and closed-end credit, sets forth the duty of creditors to retain evidence of compliance with the regulation. It also clarifies the relationship between the regulation and state law, and requires creditors to set a cap for variable rate transactions secured by a consumer's dwelling.

Subpart E (sections 226.31 through 226.34) applies to certain home mortgage transactions including high-cost, closed-end mortgages and reverse mortgages. It requires additional disclosures and provides limitations for certain home mortgage transactions having rates or fees above a certain percentage or amount, and prohibits specific acts and practices in connection with those loans. Subpart E also includes disclosure requirements for reverse mortgage transactions (open-end and closed-end credit).

The appendices to the regulation set forth model forms and clauses that creditors may use when providing open-end and closed-end disclosures. The appendices contain detailed rules for calculating the APR for open-end credit (appendix F) and closed-end credit (appendixes D and J). The last two appendixes (appendixes K and L) provide total annual loan cost rate computations and assumed loan periods for reverse mortgage transactions.

Official staff interpretations of the regulation are published in a commentary that is normally updated annually in March. Good faith compliance with the commentary protects creditors from civil liability under the act. In addition, the commentary includes mandates, which are not necessarily explicit in Regulation Z, on disclosures or other actions required of creditors. It is virtually impossible to comply with Regulation Z without reference to and reliance on the commentary.

Note: The following narrative does not encompass all the sections of Regulation Z, but rather highlights areas that have caused the most problems with the calculation of the finance charge and the calculation of the annual percentage rate.

Subpart A - General

Purpose of the TILA and Regulation Z

The Truth in Lending Act is intended to ensure that credit terms are disclosed in a meaningful way so consumers can compare credit terms more readily and knowledgeably. Before its enactment, consumers were faced with a bewildering array of credit terms and rates. It was difficult to compare loans because they were seldom presented in the same format. Now, all creditors must use the same credit terminology and expressions of rates. In addition to providing a uniform system for disclosures, the act is designed to:

- Protect consumers against inaccurate and unfair credit billing and credit card practices;
- Provide consumers with rescission rights;
- Provide for rate caps on certain dwelling-secured loans; and
- Impose limitations on home equity lines of credit and certain closed-end home mortgages.

The TILA and Regulation Z do not, however, tell financial institutions how much interest they may charge or whether they must grant a consumer a loan.

Summary of Coverage Considerations §226.1 & §226.2

Lenders must carefully consider several factors when deciding whether a loan requires Truth in Lending disclosures or is subject to other Regulation Z requirements. The coverage considerations under Regulation Z are addressed in more detail in the commentary to Regulation Z. For example, broad coverage considerations are included under section 226.1(c) of the regulation and relevant definitions appear in section 226.2.

Exempt Transactions §226.3

The following transactions are exempt from Regulation Z:

- Credit extended primarily for a business, commercial, or agricultural purpose;
- Credit extended to other than a natural person (including credit to government agencies or instrumentalities);
- Credit in excess of $25,000 and not secured by real or personal property used as the principal dwelling of the consumer;
- Public utility credit;
- Credit extended by a broker-dealer registered with the Securities and Exchange Commission (SEC) or the Commodity Futures Trading Commission (CFTC), involving securities or commodities accounts;
- Home fuel budget plans; and
- Certain student loan programs.

Footnote 4: If a credit card is involved, generally exempt credit (e.g., business or agricultural purpose credit) is still subject to requirements that govern the issuance of credit cards and liability for their unauthorized use. Credit cards must not be issued on an unsolicited basis and, if a credit card is lost or stolen, the cardholder must not be held liable for more than $50 for the unauthorized use of the card.

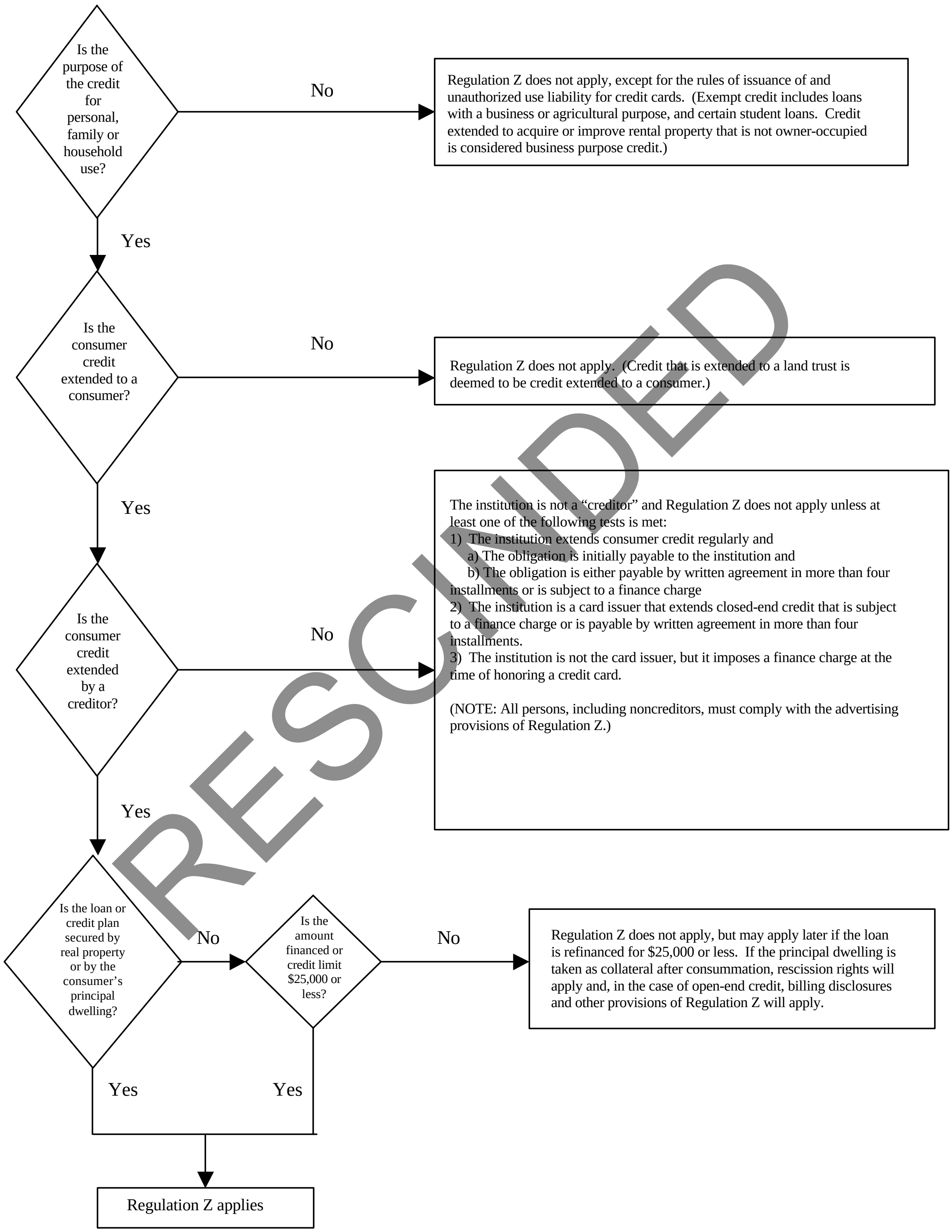
When determining whether credit is for consumer purposes, the creditor must evaluate all of the following:

- Any statement obtained from the consumer describing the purpose of the proceeds.
  - — For example, a statement that the proceeds will be used for a vacation trip would indicate a consumer purpose.
  - — If the loan has a mixed-purpose (e.g., proceeds will be used to buy a car that will be used for personal and business purposes), the lender must look to the primary purpose of the loan to decide whether disclosures are necessary. A statement of purpose from the consumer will help the lender make that decision.
  - — A checked box indicating that the loan is for a business purpose, absent any documentation showing the intended use of the proceeds, could be insufficient evidence that the loan did not have a consumer purpose.
- The consumer's primary occupation and how it relates to the use of the proceeds. The higher the correlation between the consumer's occupation and the property purchased from the loan proceeds, the greater the likelihood that the loan has a business purpose. For example, proceeds used to purchase dental supplies for a dentist would indicate a business purpose.
- Personal management of the assets purchased from proceeds. The lower the degree of the borrower's personal involvement in the management of the investment or enterprise purchased by the loan proceeds, the less likely the loan will have a business purpose. For example, money borrowed to purchase stock in an automobile company by an individual who does not work for that company would indicate a personal investment and a consumer purpose.
- The size of the transaction. The larger the size of the transaction, the more likely the loan will have a business purpose. For example, if the loan is for a $5,000,000 real estate transaction, that might indicate a business purpose.
- The amount of income derived from the property acquired by the loan proceeds relative to the borrower's total income. The lesser the income derived from the acquired property, the more likely the loan will have a consumer purpose. For example, if the borrower has an annual salary of $100,000 and receives about $500 in annual dividends

from the acquired property, that would indicate a consumer purpose.

All five factors must be evaluated before the lender can conclude that disclosures are not necessary. Normally, no one factor, by itself, is sufficient reason to determine the applicability of Regulation Z. In any event, the financial institution may routinely furnish disclosures to the consumer. Disclosure under such circumstances does not control whether the transaction is covered, but can assure protection to the financial institution and compliance with the law.

Coverage Considerations under Regulation Z



Determination of Finance Charge and APR

Finance Charge (Open-End and Closed-End Credit) §226.4

The finance charge is a measure of the cost of consumer credit represented in dollars and cents. Along with APR disclosures, the disclosure of the finance charge is central to the uniform credit cost disclosure envisioned by the TILA.

The finance charge does not include any charge of a type payable in a comparable cash transaction. Examples of charges payable in a comparable cash transaction may include taxes, title, license fees, or registration fees paid in connection with an automobile purchase.

Finance charges include any charges or fees payable directly or indirectly by the consumer and imposed directly or indirectly by the financial institution either as an incident to or as a condition of an extension of consumer credit. The finance charge on a loan always includes any interest charges and often, other charges. Regulation Z includes examples, applicable both to open-end and closed-end credit transactions, of what must, must not, or need not be included in the disclosed finance charge (§226.4(b)).

Accuracy Tolerances (Closed-End Credit) §§226.18(d) & 226.23(h)

Regulation Z provides finance charge tolerances for legal accuracy that should not be confused with those provided in the TILA for reimbursement under regulatory agency orders. As with disclosed APRs, if a disclosed finance charge were legally accurate, it would not be subject to reimbursement.

Under TILA and Regulation Z, finance charge disclosures for open-end credit must be accurate since there is no tolerance for finance charge errors. However, both TILA and Regulation Z permit various finance charge accuracy tolerances for closed-end credit.

Tolerances for the finance charge in a closed-end transaction are generally $5 if the amount financed is less than or equal to $1,000 and $10 if the amount financed exceeds $1,000. Tolerances for certain transactions consummated on or after September 30, 1995 are noted below.

- Credit secured by real property or a dwelling (**closed-end credit only**):
  - — The disclosed finance charge is considered accurate if it does not vary from the actual finance charge by more than $100.
  - — Overstatements are not violations.
- Rescission rights after the three-business-day rescission period (**closed-end credit only**):
  - — The disclosed finance charge is considered accurate if it does not vary from the actual finance charge by more than one-half of 1 percent of the credit extended.
  - — The disclosed finance charge is considered accurate if it does not vary from the actual finance charge by more than 1 percent of the credit extended for the initial and subsequent refinancings of residential mortgage transactions when the new loan is made at a different financial institution. (This excludes high cost mortgage loans subject to §226.32, transactions in which there are new advances, and new consolidations.)
- Rescission rights in foreclosure:
  - — The disclosed finance charge is considered accurate if it does not vary from the actual finance charge by more than $35.
  - — Overstatements are not considered violations.
  - — The consumer can rescind if a mortgage broker fee is not included as a finance charge.

*Note***:** Normally, the finance charge tolerance for a rescindable transaction is either 0.5 percent of the credit transaction or, for certain refinancings, 1 percent of the credit transaction. However, in the event of a foreclosure, the consumer may exercise the right of rescission if the disclosed finance charge is understated by more than $35.

See the "Finance Charge Tolerances" charts within these examination procedures for help in determining appropriate finance charge tolerances.

Calculating the Finance Charge (Closed-End Credit)

One of the more complex tasks under Regulation Z is determining whether a charge associated with an extension of credit must be included in, or excluded from, the disclosed finance charge. The finance charge initially includes any charge that is, or will be, connected with a specific loan. Charges imposed by third parties are finance charges if the financial institution requires use of the third party. Charges imposed by settlement or closing agents are finance charges if the bank requires the specific service that gave rise to the charge and the charge is not otherwise excluded. The "Finance Charge Tolerances" charts within this document briefly summarize the rules that must be considered.

Prepaid Finance Charges §226.18(b)

A prepaid finance charge is any finance charge paid separately to the financial institution or to a third party, in cash or by check before or at closing, settlement, or consummation of a transaction, or withheld from the proceeds of the credit at any time.

Prepaid finance charges effectively reduce the amount of funds available for the consumer's use, usually before or at the time the transaction is consummated.

Examples of finance charges frequently prepaid by consumers are borrower's points, loan origination fees, real estate construction inspection fees, odd days' interest (interest attributable to part of the first payment period when that period is longer than a regular payment period), mortgage guarantee insurance fees paid to the Federal Housing Administration, private mortgage insurance (PMI) paid to such companies as the Mortgage Guaranty Insurance Company (MGIC), and, in non-real-estate transactions, credit report fees.

Precomputed Finance Charges

A precomputed finance charge includes, for example, interest added to the note amount that is computed by the add-on, discount, or simple interest methods. If reflected in the face amount of the debt instrument as part of the consumer's obligation, finance charges that are not viewed as prepaid finance charges are treated as precomputed finance charges that are earned over the life of the loan.

Finance Charge Chart

FINANCE CHARGE = DOLLAR COST OF CONSUMER CREDIT: It includes any charge payable directly or indirectly by the consumer and imposed directly or indirectly by the creditor as a condition of or incident to the extension of credit.

CHARGES ALWAYS INCLUDED

- Interest
- Transaction fees
- Loan origination fees
Consumer points
- Credit guarantee insurance premiums
- Charges imposed on the creditor for purchasing the loan, which are passed on to the consumer
- Discounts for inducing payment by means other than credit
- Mortgage broker fees
- Other examples: Fee for preparing TILA disclosures; real estate construction loan inspection fees; fees for post-consummation tax or flood service policy; required credit life insurance charges

CHARGES INCLUDED UNLESS CONDITIONS ARE MET → CONDITIONS (Any loan)

CHARGES INCLUDED UNLESS CONDITIONS ARE MET	CONDITIONS (Any loan)
Premiums for credit life, A&H, or loss of income insurance	Insurance not required, disclosures are made, and consumer authorizes
Debt cancellation fees	Coverage not required, disclosures are made, and consumer authorizes
Premiums for property or liability insurance	Consumer selects insurance company and disclosures are made
Premiums for vendor's single interest (VSI) insurance	Insurer waives right of subrogation, consumer selects insurance company, and disclosures are made
Security interest charges (filing fees), insurance in lieu of filing fees and certain notary fees	The fee is for lien purposes, prescribed by law, payable to a third public official and is itemized and disclosed
Charges imposed by third parties	Use of the third party is not required to obtain loan and creditor does not retain the charge
Charges imposed by third party closing agents	Creditor does not require and does not retain the fee for the particular service
Appraisal and credit report fees	Application fees, if charged to all applicants, are not finance charges. Application fees may include appraisal or credit report fees.

CHARGES NOT INCLUDED (Residential mortgage transactions and loans secured by real estate)

- Fees for title insurance, title examination, property survey, etc.
- Fees for preparing loan documents, mortgages, and other settlement documents
- Amounts required to be paid into escrow, if not otherwise included in the finance charge
- Notary fees
- Pre-consummation flood and pest inspection fees
- Appraisal and credit report fees

CHARGES NEVER INCLUDED

- Charges payable in a comparable cash transaction.
- Fees for unanticipated late payments
- Overdraft fees not agreed to in writing
- Seller's points
- Participation or membership fees
- Discount offered by the seller to induce payment by cash or other means not involving the use of a credit card
- Interest forfeited as a result of interest reduction required by law
- Charges absorbed by the creditor as a cost of doing business

Instructions for the Finance Charge Chart

The finance charge initially includes any charge that is, or will be, connected with a specific loan. Charges imposed by third parties are finance charges if the creditor requires use of the third party. Charges imposed on the consumer by a settlement agent are finance charges only if the creditor requires the particular services for which the **settlement agent** is charging the borrower and the charge is not otherwise excluded from the finance charge.

Immediately below the finance charge definition, the chart presents five captions applicable to determining whether a loan related charge is a finance charge.

The first caption is **charges always included**. This category focuses on specific charges given in the regulation or commentary as examples of finance charges.

The second caption, **charges included unless conditions are met**, focuses on charges that must be included in the finance charge unless the creditor meets specific disclosure or other conditions to exclude the charges from the finance charge.

The third caption, **conditions**, focuses on the conditions that need to be met if the charges identified to the left of the conditions are permitted to be excluded from the finance charge. Although most charges under the second caption may be included in the finance charge at the creditor's option, third party charges and application fees (listed last under the third caption) must be excluded from the finance charge if the relevant conditions are met. However, inclusion of appraisal and credit report charges as part of the application fee is optional.

The fourth caption, **charges not included**, identifies fees or charges that are not included in the finance charge under conditions identified by the caption. If the credit transaction is secured by real property or the loan is a residential mortgage transaction, the charges identified in the column, if they are bona fide and reasonable in amount, must be excluded from the finance charge. For example, if a consumer loan is secured by a vacant lot or commercial real estate, any appraisal fees connected with the loan must not be included in the finance charge.

The fifth caption, **charges never included**, lists specific charges provided by the regulation as examples of those that automatically are not finance charges (e.g., fees for unanticipated late payments).

Annual Percentage Rate Definition §226.22 (Closed-End Credit)

Credit costs may vary depending on the interest rate, the amount of the loan and other charges, the timing and amounts of advances, and the repayment schedule. The APR, which must be disclosed in nearly all consumer credit transactions, is designed to take into account all relevant factors and to provide a uniform measure for comparing the cost of various credit transactions.

The APR is a measure of the cost of credit, expressed as a nominal yearly rate. It relates the amount and timing of value received by the consumer to the amount and timing of payments made. The disclosure of the APR is central to the uniform credit cost disclosure envisioned by the TILA.

The value of a closed-end credit APR must be disclosed as a single rate only, whether the loan has a single interest rate, a variable interest rate, a discounted variable interest rate, or graduated payments based on separate interest rates (step rates), and it must appear with the segregated disclosures. Segregated disclosures are grouped together and do not contain any information not directly related to the disclosures required under §226.18.

Since an APR measures the total cost of credit, including costs such as transaction charges or premiums for credit guarantee insurance, it is not an "interest" rate, as that term is generally used. APR calculations do not rely on definitions of interest in state law and often include charges, such as a commitment fee paid by the consumer, that are not viewed by some state usury statutes as interest. Conversely, an APR might not include a charge, such as a credit report fee in a real property transaction, which some state laws might view as interest for usury purposes. Furthermore, measuring the timing of value received and of payments made, which is essential if APR calculations are to be accurate, must be consistent with parameters under Regulation Z.

The APR is often considered to be the finance charge expressed as a percentage. However, two loans could require the same finance charge and still have different APRs because of differing values of the amount financed or of payment schedules. For example, the APR is 12 percent on a loan with an amount financed of $5,000 and 36 equal monthly payments of $166.07 each. It is 13.26 percent on a loan with an amount financed of $4,500 and 35 equal monthly payments of $152.18 each and final payment of $152.22. In both cases the finance charge is $978.52. The APRs on these example loans are not the same because an APR does not only reflect the finance charge. It relates the amount and timing of value received by the consumer to the amount and timing of payments made.

The APR is a function of:

- The amount financed, which is not necessarily equivalent to the loan amount. If the consumer must pay at closing a separate 1 percent loan origination fee (prepaid finance charge) on a $100,000 residential mortgage loan, the loan amount is $100,000, but the amount financed would be $100,000 less the $1,000 loan fee, or $99,000.

- The finance charge, which is not necessarily equivalent to the total interest amount.

  — If the consumer must pay a $25 credit report fee for an auto loan, the fee must be included in the finance charge. The finance charge in that case is the sum of the interest on the loan (i.e., interest generated by the application of a percentage rate against the loan amount) plus the $25 credit report fee.

  — If the consumer must pay a $25 credit report fee for a home improvement loan secured by real property, the credit report fee must be excluded from the finance charge. The finance charge in that case would be only the interest on the loan.

  — Interest, which is defined by state or other federal law, is not defined by Regulation Z.

- The payment schedule, which does not necessarily include only principal and interest (P + I) payments.

  — If the consumer borrows $2,500 for a vacation trip at 14 percent simple interest per annum and repays that amount with 25 equal monthly payments beginning one month from consummation of the transaction, the monthly P + I payment will be $115.87, if all months are considered equal, and the amount financed would be $2,500. If the consumer's payments are increased by $2.00 a month to pay a non-financed $50 loan fee during the life of the loan, the amount financed would remain at $2,500 but the payment schedule would be increased to $117.87 a month, the finance charge would increase by $50, and there would be a corresponding increase in the APR. This would be the case whether or not state law defines the $50 loan fee as interest.

  — If the loan above has 55 days to the first payment and the consumer prepays interest at consummation ($24.31 to cover the first 25 days), the amount financed would be $2,500 - $24.31, or $2,475.69. Although the amount financed has been reduced to reflect the consumer's reduced use of available funds at consummation, the time interval during which the consumer has use of the $2,475.69, 55 days to the first payment, has not changed. Since the first payment period exceeds the limitations of the regulation's minor irregularities provisions (see §226.17(c)(4)), it may not be treated as regular. In calculating the APR, the first payment period must not be reduced by 25 days (i.e., the first payment period may not be treated as one month).

Financial institutions may, if permitted by state or other law, precompute interest by applying a rate against a loan balance using a simple interest, add-on, discount or some other method, and may earn interest using a simple interest accrual system, the Rule of 78's (if permitted by law) or some other method. Unless the financial institution's internal interest earnings and accrual methods involve a simple interest rate based on a 360-day year that is applied over actual days (even that is important only for determining the accuracy of the payment schedule), it is not relevant in calculating an APR, since an APR is not an interest rate (as that term is commonly used under state or other law). Since the APR normally need not rely on the internal accrual systems of a bank, it always may be computed after the loan terms have been agreed upon (as long as it is disclosed before actual consummation of the transaction).

Special Requirements for Calculating the Finance Charge and APR

Proper calculation of the finance charge and APR are of primary importance. The regulation requires that the terms "finance charge" and "annual percentage rate" be disclosed more conspicuously than any other required disclosure. The finance charge and APR, more than any other disclosures, enable consumers to understand the cost of the credit and to comparison shop for credit. A creditor's failure to disclose those values accurately can result in significant monetary damages to the creditor, either from a class action lawsuit or from a regulatory agency's order to reimburse consumers for violations of law.

Footnote 45d: If an annual percentage rate or finance charge is disclosed incorrectly, the error is not, in itself, a violation of the regulation if:

- The error resulted from a corresponding error in a calculation tool **used in good faith** by the financial institution.
- Upon discovery of the error, the financial institution promptly discontinues use of that calculation tool for disclosure purposes.
- The financial institution notifies the Federal Reserve Board in writing of the error in the calculation tool.

When a financial institution claims a calculation tool was used in good faith, the financial institution assumes a reasonable degree of responsibility for ensuring that the tool in question provides the accuracy required by the regulation. For example, the financial institution might verify the results obtained using the tool by comparing those results to the figures obtained by using another calculation tool. The financial institution might also verify that the tool, if it is designed to operate under the actuarial method, produces figures similar to those provided by the examples in appendix J to the regulation. The calculation tool should be checked for accuracy before it is first used and periodically thereafter.

Subpart B - Open-End Credit

The following is not a complete discussion of the open-end credit requirements in the Truth in Lending Act. Instead, the information provided below is offered to clarify otherwise confusing terms and requirements. Refer to §§226.5 through 226.16 and related commentary for a more thorough understanding of the Act.

Finance Charge (Open-End Credit) §226.6(a)

Each finance charge imposed must be individually itemized. The aggregate total amount of the finance charge need not be disclosed.

Determining the Balance and Computing the Finance Charge

The examiner must know how to compute the balance to which the periodic rate is applied. Common methods used are the previous balance method, the daily balance method, and the average daily balance method, which are described as follows:

- *Previous balance method* – The balance on which the periodic finance charge is computed is based on the balance outstanding at the start of the billing cycle. The periodic rate is multiplied by this balance to compute the finance charge.
- *Daily balance method* – A daily periodic rate is applied to either the balance on each day in

the cycle or the sum of the balances on each of the days in the cycle. If a daily periodic rate is multiplied by the balance on each day in the billing cycle, the finance charge is the sum of the products. If the daily periodic rate is multiplied by the sum of all the daily balances, the result is the finance charge.

- *Average daily balance method* – The average daily balance is the sum of the daily balances (either including or excluding current transactions) divided by the number of days in the billing cycle. A periodic rate is then multiplied by the average daily balance to determine the finance charge. If the periodic rate is a daily one, the product of the rate multiplied by the average balance is multiplied by the number of days in the cycle.

In addition to those common methods, financial institutions have other ways of calculating the balance to which the periodic rate is applied. By reading the financial institution's explanation, the examiner should be able to calculate the balance to which the periodic rate was applied. In some cases, the examiner may need to obtain additional information from the financial institution to verify the explanation disclosed. Any inability to understand the disclosed explanation should be discussed with management, who should be reminded of Regulation Z's requirement that disclosures be clear and conspicuous.

When a balance is determined without first deducting all credits and payments made during the billing cycle, that fact and the amount of the credits and payments must be disclosed.

If the financial institution uses the daily balance method and applies a single daily periodic rate, disclosure of the balance to which the rate was applied may be stated as any of the following:

- A balance for each day in the billing cycle. The daily periodic rate is multiplied by the balance on each day and the sum of the products is the finance charge.
- A balance for each day in the billing cycle on which the balance in the account changes. The finance charge is figured by the same method as discussed previously, but the statement shows the balance only for those days on which the balance changed.
- The sum of the daily balances during the billing cycle. The balance on which the finance charge is computed is the sum of all the daily balances in the billing cycle. The daily periodic rate is multiplied by that balance to determine the finance charge.
- The average daily balance during the billing cycle. If this is stated, however, the financial institution must explain somewhere on the periodic statement or in an accompanying document that the finance charge is or may be determined by multiplying the average daily balance by the number of days in the billing cycle, rather than by multiplying the product by the daily periodic rate.

If the financial institution uses the daily balance method, but applies two or more daily periodic rates, the sum of the daily balances may not be used. Acceptable ways of disclosing the balances include:

- A balance for each day in the billing cycle;
- A balance for each day in the billing cycle on which the balance in the account changes; or
- Two or more average daily balances. If the average daily balances are stated, the financial institution shall indicate on the periodic statement or in an accompanying document that the finance charge is or may be determined by multiplying each of the average daily balances by the number of days in the billing cycle (or if the daily rate varies, by multiplying the number of days that the applicable rate was in effect), multiplying each of the results by the applicable daily periodic rate, and adding the products together.

In explaining the method used to find the balance on which the finance charge is computed, the financial institution need not reveal how it allocates payments or credits. That information may be disclosed as additional information, but all required information must be clear and conspicuous.

Finance Charge Resulting from Two or More Periodic Rates

Some financial institutions use more than one periodic rate in computing the finance charge. For example, one rate may apply to balances up to a certain amount and another rate to balances more than that amount. If two or more periodic rates apply, the financial institution must disclose all rates and conditions. The range of balances to which each rate applies also must be disclosed. It is not necessary, however, to break the finance charge into separate components based on the different rates.

Annual Percentage Rate (Open-End Credit)

Accuracy Tolerance §226.14

The disclosed annual percentage rate (APR) on an open-end credit account is accurate if it is within one-eighth of 1 percentage point of the APR calculated under Regulation Z.

Determination of APR

The regulation states two basic methods for determining the APR in open-end credit transactions. The first involves multiplying each periodic rate by the number of periods in a year. This method is used for disclosing:

- The corresponding APR in the initial disclosures;
- The corresponding APR on periodic statements;
- The APR in early disclosures for credit card accounts;
- The APR in early disclosures for home-equity plans;
- The APR in advertising; and
- The APR in oral disclosures.

The corresponding APR is prospective. In other words, it does not involve any particular finance charge or periodic balance.

The second method is the quotient method, used in computing the APR for periodic statements. The quotient method reflects the annualized equivalent of the rate that was actually applied during a cycle. This rate, also known as the historical rate, will differ from the corresponding APR if the creditor applies minimum, fixed, or transaction charges to the account during the cycle.

If the finance charge is determined by applying one or more periodic rates to a balance, and does not include any of the charges just mentioned, the financial institution may compute the historical rate using the quotient method. In that method, the financial institution divides the total finance charge for the cycle by the sum of the balances to which the periodic rates were applied and multiplies the quotient (expressed as a percentage) by the number of cycles in a year.

Alternatively, the financial institution may use the method for computing the corresponding APR. In that method, the financial institution multiplies each periodic rate by the number of periods in one year. If the finance charge includes a minimum, fixed, or transaction charge, the financial institution must use the appropriate variation of the quotient method. When transaction charges are imposed, the financial institution should refer to appendix F of this handbook for computational examples.

The regulation also contains a computation rule for small finance charges. If the finance charge includes a minimum, fixed, or transaction charge, and the total finance charge for the cycle does not exceed 50 cents, the financial institution may multiply each applicable periodic rate by the number of periods in a year to compute the APR.

Optional calculation methods also are provided for accounts involving daily periodic rates (§226.14(d)).

Brief Outline for Open-End Credit APR Calculations on Periodic Statements

Note: Assume monthly billing cycles for each of the calculations below.

I. APR when finance charge is determined solely by applying one or more periodic rates:

A. Monthly periodic rates:

1. Monthly rate x 12 = APR

or

2. (Total finance charge / applicable balance[2]) x 12 = APR

This calculation may be used when different rates apply to different balances.

A. Daily periodic rates:

1. Daily rate x 365 = APR

or

2. (Total finance charge / average daily balance) x 12 = APR

or

3. (Total finance charge / sum of balances) x 365 = APR

II. APR when finance charge includes a minimum, fixed, or other charge that is not calculated using a periodic rate (and does not include charges related to a specific transaction, like cash advance fees):

A. Monthly periodic rates:

1. (Total finance charge / amount of applicable balance[3]) x 12 = APR[4]

B. Daily periodic rates

1. (Total finance charge / amount of applicable balance[1]) X 365 = APR[3]

2. The following may be used if at least a portion of the finance charge is determined by the application of a daily periodic rate. If not, use the formula above.

a. (Total finance charge / average daily balance) x 12 = APR[3]

or

b. (Total finance charge / sum of balances) x 365 = APR[3]

C. Monthly and daily periodic rates

1. If the finance charge imposed during the billing cycle does not exceed $.50 for a monthly or longer billing cycles (or pro rata part of $.50 for a billing cycle shorter than monthly), the APR may be calculated by multiplying the monthly rate by 12 or the daily rate by 365.

III. If the total finance charge included a charge related to a specific transaction (such as a cash advance fee), even if the total finance charge also included any other minimum, fixed, or other charge not calculated using a periodic rate, then the monthly and daily APRs are calculated as follows: (total finance charge / the greater of: the transaction amounts that created the transaction fees or the sum of the balances and other amounts on which a finance charge was imposed during the billing cycle[5]) X number of billing cycles in a year (12) = APR[6]

[2] If zero, no APR can be determined. The amount of applicable balance is the balance calculation method and may include the average daily balance, adjusted balance, or previous balance method.

[3] If zero, no APR can be determined. The amount of applicable balance is the balance calculation method and may include the average daily balance, adjusted balance, or previous balance method.

[4] Loan fees, points, or similar finance charges that relate to the opening of the account must not be included in the calculation of the APR.

[5] The sum of the balances may include the average daily balance, adjusted balance, or previous balance method. Where a portion of the finance charge is determined by application of one or more daily periodic rates, sum of the balances also means the average of daily balances.

[6] Cannot be less than the highest periodic rate applied, expressed as an APR.

Subpart C - Closed-End Credit

The following is not a complete discussion of the closed-end credit requirements in the Truth in Lending Act. Instead, the information provided below is offered to clarify otherwise confusing terms and requirements. Refer to §§226.17 through 226.24 and related commentary for a more thorough understanding of the Act.

Finance Charge (Closed-End Credit) §226.17(a)

The aggregate total amount of the finance charge must be disclosed. Each finance charge imposed need not be individually itemized and must not be itemized with the segregated disclosures.

Annual Percentage Rate (Closed-End Credit) §226.22

Accuracy Tolerances

The disclosed APR on a closed-end transaction is accurate for:

- Regular transactions (which include any single advance transaction with equal payments and equal payment periods, or an irregular first payment period and/or a first or last irregular payment), if it is within one-eighth of 1 percentage point of the APR calculated under Regulation Z (§226.22(a)(2)).
- Irregular transactions (which include multiple advance transactions and other transactions not considered regular), if it is within one-quarter of 1 percentage point of the APR calculated under Regulation Z (§226.22(a)(3)).
- Mortgage transactions, if it is within one-eighth of 1 percentage point for regular transactions or one-quarter of 1 percentage point for irregular transactions **and**:

  i. The rate results from the disclosed finance charge; **and**

  ii. The disclosed finance charge would be considered accurate under §§226.18(d)(1) or 226.23(g) or (h) (§226.22(a)(4)).

Note: There is an additional tolerance for mortgage loans when the disclosed finance charge is calculated incorrectly but is considered accurate under §§226.18(d)(1) or 226.23(g) or (h) (§226.22(a)(5)).

Construction Loans §226.17(c)(6) and Appendix D

Construction and certain other multiple advance loans pose special problems in computing the finance charge and APR. In many instances, the amount and dates of advances are not predictable with certainty since they depend on the progress of the work. Regulation Z provides that the APR and finance charge for such loans may be estimated for disclosure.

At its option, the financial institution may rely on the representations of other parties to acquire necessary information (for example, it might look to the consumer for the dates of advances). In addition, if either the amounts or dates of advances are unknown (even if some of them are known), the financial institution may, at its option, use appendix D to the regulation to make calculations and disclosures. The finance charge and payment schedule obtained through appendix D may be used with volume one of the Federal Reserve Board's APR tables or with any other appropriate computation tool to determine the APR. If the financial institution elects not to use appendix D, or if appendix D cannot be applied to a loan (e.g., appendix D does not apply to a combined construction-permanent loan if the payments for the permanent loan begin during the construction period), the financial institution must make its estimates under §226.17(c)(2) and calculate the APR using multiple advance formulas.

On loans involving a series of advances under an agreement to extend credit up to a certain amount, a financial institution may treat all of the advances as a single transaction or disclose each advance as a separate transaction. If advances are disclosed separately, disclosures must be provided before each advance occurs, with the disclosures for the first advance provided before consummation.

In a transaction that finances the construction of a dwelling that may or will be permanently financed by the same financial institution, the construction-permanent financing phases may be disclosed in one of three ways listed below.

- As a single transaction, with one disclosure combining both phases.
- As two separate transactions, with one disclosure for each phase.
- As more than two transactions, with one disclosure for each advance and one for the permanent financing phase.

If two or more disclosures are furnished, buyer's points or similar amounts imposed on the consumer may be allocated among the transactions in any manner the financial institution chooses, as long as the charges are not applied more than once. In addition, if the financial institution chooses to give two sets of disclosures and the consumer is obligated for both construction and permanent phases at the outset, both sets of disclosures must be given to the consumer initially, before consummation of each transaction occurs.

If the creditor requires interest reserves for construction loans, special appendix D rules apply that can make the disclosure calculations quite complicated. The amount of interest reserves included in the commitment amount must not be treated as a prepaid finance charge.

If the lender uses appendix D for construction-only loans with required interest reserves, the lender must estimate construction interest using the interest reserve formula in appendix D. The lender's own interest reserve values must be completely disregarded for disclosure purposes.

If the lender uses appendix D for combination construction-permanent loans, the calculations can be much more complex. Appendix D is used to estimate the construction interest, which is then measured against the lender's contractual interest reserves.

If the interest reserve portion of the lender's contractual commitment amount exceeds the amount of construction interest estimated under appendix D, the excess value is considered part of the amount financed if the lender has contracted to disburse those amounts whether they ultimately are needed to pay for accrued construction interest. If the lender will not disburse the excess amount if it is not needed to pay for accrued construction interest, the excess amount must be ignored for disclosure purposes.

Calculating the Annual Percentage Rate §226.22

The APR must be determined under one of the following:

- The actuarial method, which is defined by Regulation Z and explained in appendix J to the regulation.
- The U.S. Rule, which is permitted by Regulation Z and briefly explained in appendix J to the regulation. The U.S. Rule is an accrual method that seems to have first surfaced officially in an early nineteenth century United States Supreme Court case, Story v. Livingston (38 U.S. 359).

Whichever method is used by the financial institution, the rate calculated will be accurate if it is able to "amortize" the amount financed while it generates the finance charge under the accrual method selected. Financial institutions also may rely on minor irregularities and accuracy tolerances in the regulation, both of which effectively permit somewhat imprecise, but still legal, APRs to be disclosed.

360-Day and 365-Day Years §226.17(c)(3)

Confusion often arises over whether to use the 360-day or 365-day year in computing interest, particularly when the finance charge is computed by applying a daily rate to an unpaid balance. Many single payment loans or loans payable on demand are in this category. There are also loans in this category that call for periodic installment payments.

Regulation Z does not require the use of one method of interest computation in preference to another (although state law may). It does, however, permit financial institutions to disregard the fact that months have different numbers of days when calculating and making disclosures. This means financial institutions may base their disclosures on calculation tools that assume all months have an equal number of days, even if their practice is to take account of the variations in months to collect interest.

For example, a financial institution may calculate disclosures using a financial calculator based on a 360-day year with 30-day months, when, in fact, it collects interest by applying a factor of 1/365 of the annual interest rate to actual days.

Disclosure violations may occur, however, when a financial institution applies a daily interest factor based on a 360-day year to the actual number of days between payments. In those situations, the financial institution must disclose the higher values of the finance charge, the APR, and the payment schedule resulting from this practice.

For example, a 12 percent simple interest rate divided by 360 days results in a daily rate of .033333 percent. If no charges are imposed except interest, and the amount financed is the same as the loan amount, applying the daily rate on a daily basis for a 365-day year on a $10,000 one year, single payment, unsecured loan results in an APR of 12.17 percent (.033333% x 365 = 12.17%), and a finance charge of $1,216.67. There would be a violation if the APR were disclosed as 12 percent or if the finance charge were disclosed as $1,200 (12% x $10,000).

However, if there are no other charges except interest, the application of a 360-day year daily rate over 365 days on a regular loan would not result in an APR in excess of the one eighth of one percentage point APR tolerance unless the nominal interest rate is greater than 9 percent. For irregular loans, with one-quarter of 1 percentage point APR tolerance, the nominal interest rate would have to be greater than 18 percent to exceed the tolerance.

Variable Rate Information §226.18(f)

If the terms of the legal obligation allow the financial institution, after consummation of the transaction, to increase the APR, the financial institution must furnish the consumer with certain information on variable rates. Graduated payment mortgages and step-rate transactions without a variable rate feature are not considered variable rate transactions. In addition, variable rate disclosures are not applicable to rate increases resulting from delinquency, default, assumption, acceleration, or transfer of the collateral.

Some of the more important transaction-specific variable rate disclosure requirements under §226.18 follow.

- Disclosures for variable rate loans must be given for the full term of the transaction and must be based on the terms in effect at the time of consummation.
- If the variable rate transaction includes either a seller buydown that is reflected in a contract or a consumer buydown, the disclosed APR should be a composite rate based on the lower rate for the buydown period and the rate that is the basis for the variable rate feature for the remainder of the term.
- If the initial rate is not determined by the index or formula used to make later interest rate adjustments, as in a discounted variable rate transaction, the disclosed APR must reflect a composite rate based on the initial rate for as long as it is applied and, for the remainder of the term, the rate that would have been applied using the index or formula at the time of consummation (i.e., the fully indexed rate).
  - If a loan contains a rate or payment cap that would prevent the initial rate or payment, at the time of the adjustment, from changing to the fully indexed rate, the effect of that rate or payment cap needs to be reflected in the disclosures.
  - The index at consummation need not be used if the contract provides a delay in the implementation of changes in an index value (e.g., the contract indicates that future rate changes are based on the index value in effect for some specified period, like 45 days before the change date). Instead, the financial institution may use any rate from the date of consummation back to the beginning of the specified period (e.g., during the previous 45-day period).

- If the initial interest rate is set according to the index or formula used for later adjustments, but is set at a value as of a date before consummation, disclosures should be based on the initial interest rate, even though the index may have changed by the consummation date.

For variable-rate loans that are not secured by the consumer's principal dwelling or that are secured by the consumer's principal dwelling but have a term of one year or less, creditors must disclose the circumstances under which the rate may increase, any limitations on the increase, the effect of an increase, and an example of the payment terms that would result from an increase. §226.18(f)(1).

For variable-rate consumer loans secured by the consumer's principal dwelling and having a maturity of more than one year, creditors must state that the loan has a variable-rate feature and that disclosures were previously given. (§226.18(f)(2)) Extensive disclosures about the loan program are provided when consumers apply for such a loan (§226.19(b), and throughout the loan term when the rate or payment amount is changed (§226.20(c)).

Payment Schedule §226.18(g)

The disclosed payment schedule must reflect all components of the finance charge. It includes all payments scheduled to repay loan principal, interest on the loan, and any other finance charge payable by the consumer after consummation of the transaction.

However, any finance charge paid separately before or at consummation (e.g., odd days' interest) is not part of the payment schedule. It is a prepaid finance charge that must be reflected as a reduction in the value of the amount financed.

At the creditor's option, the payment schedule may include amounts beyond the amount financed and finance charge (e.g., certain insurance premiums or real estate escrow amounts such as taxes added to payments). However, when calculating the APR, the creditor must disregard such amounts.

If the obligation is a renewable balloon payment instrument that unconditionally obligates the financial institution to renew the short-term loan at the consumer's option or to renew the loan subject to conditions within the consumer's control, the payment schedule must be disclosed using the longer term of the renewal period or periods. The long-term loan must be disclosed with a variable rate feature.

If there are no renewal conditions or if the financial institution guarantees to renew the obligation in a refinancing, the payment schedule must be disclosed using the shorter balloon payment term. The short-term loan must be disclosed as a fixed rate loan, unless it contains a variable rate feature during the initial loan term.

Amount Financed §226.18(b)

Definition

The amount financed is the net amount of credit extended for the consumer's use. It should not be assumed that the amount financed under the regulation is equivalent to the note amount, proceeds, or principal amount of the loan. The amount financed normally equals the total of payments less the finance charge.

To calculate the amount financed, all amounts and charges connected with the transaction, either paid separately or included in the note amount, must first be identified. Any prepaid, precomputed, or other finance charge must then be determined.

The amount financed must not include any finance charges. If finance charges have been included in the obligation (either prepaid or precomputed), they must be subtracted from the face amount of the obligation when determining the amount financed. The resulting value must be reduced further by an amount equal to any prepaid finance charge paid separately. The final resulting value is the amount financed.

When calculating the amount financed, finance charges (whether in the note amount or paid separately) should not be subtracted more than once from the total amount of an obligation. Charges not in the note amount and not included in the finance charge (e.g., an appraisal fee paid separately in cash on a real estate loan) are not required to be disclosed under Regulation Z and must not be included in the amount financed.

In a multiple advance construction loan, proceeds placed in a temporary escrow account and awaiting disbursement in draws to the developer are not considered part of the amount financed until actually disbursed. Thus, if the entire commitment amount is disbursed into the lender's escrow account, the lender must not base disclosures on the assumption that all funds were disbursed immediately, even if the lender pays interest on the escrowed funds.

Required Deposit §226.18(r)

A required deposit, with certain exceptions, is one that the financial institution requires the consumer to maintain as a condition of the specific credit transaction. It can include a compensating balance or a deposit balance that secures the loan. The effect of a required deposit is not reflected in the APR. Also, a required deposit is not a finance charge since it is eventually released to the consumer. A deposit that earns at least 5 percent per year need not be considered a required deposit.

Calculating the Amount Financed

A consumer signs a note secured by real property in the amount of $5,435. The note amount includes $5,000 in proceeds disbursed to the consumer, $400 in precomputed interest, $25 paid to a credit reporting agency for a credit report, and a $10 service charge. Additionally, the consumer pays a $50 loan fee separately in cash at consummation. The consumer has no other debt with the financial institution. The amount financed is $4,975.

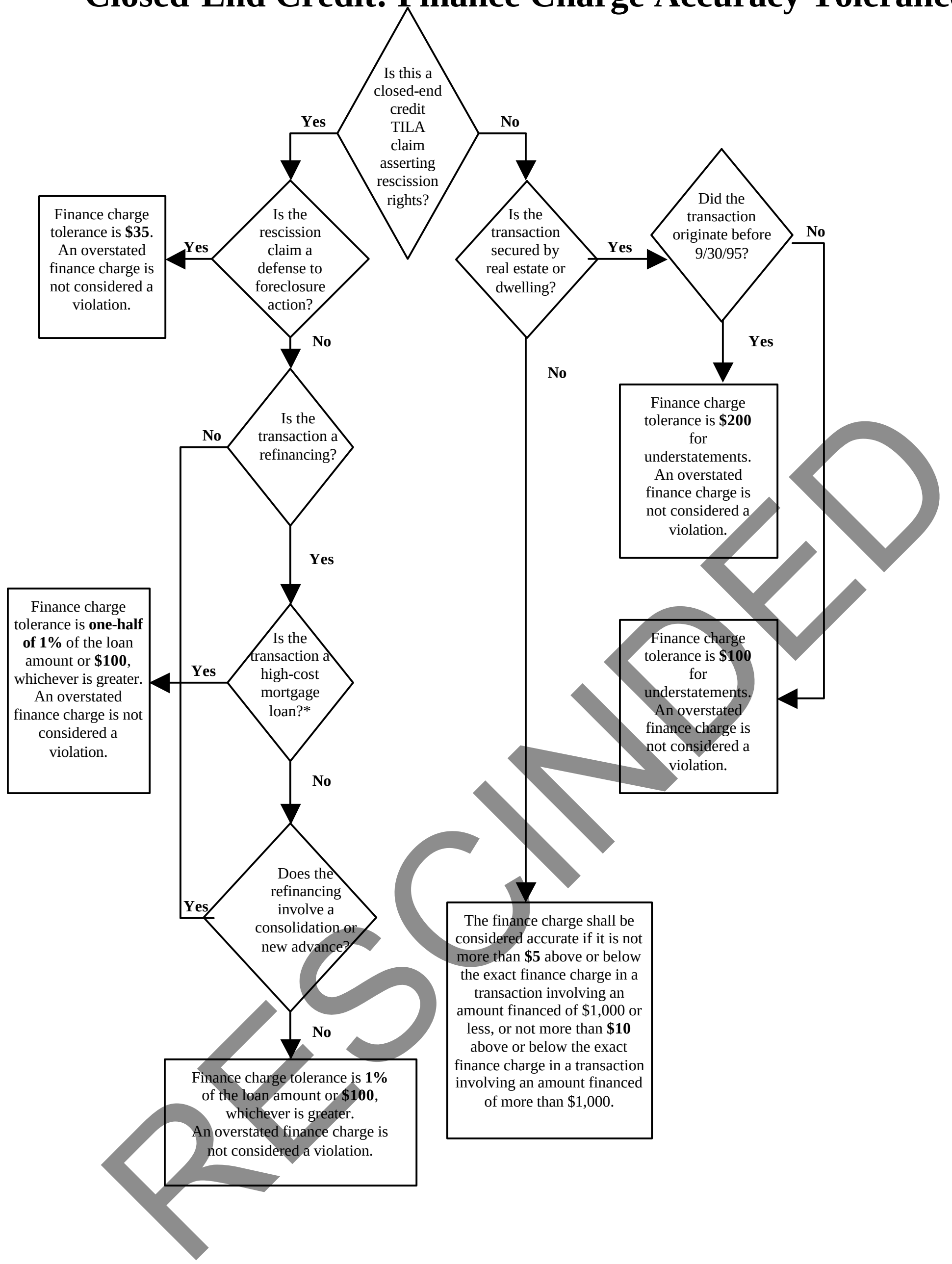
The amount financed may be calculated by first subtracting all finance charges included in the note amount ($5,435 - $400 - $10 = $5,025). The $25 credit report fee is not a finance charge because the loan is secured by real property. The $5,025 is further reduced by the amount of prepaid finance charges paid separately, for an amount financed of $5,025 - $50 = $4,975. The answer is the same whether finance charges included in the obligation are considered prepaid or precomputed finance charges.

The financial institution may treat the $10 service charge as an addition to the loan amount and not as a prepaid finance charge. If it does, the loan principal would be $5,000. The $5,000 loan principal does not include either the $400 or the $10 precomputed finance charge in the note. The loan principal is increased by other amounts that are financed which are not part of the finance charge (the $25 credit report fee) and reduced by any prepaid finance charges (the $50 loan fee, not the $10 service charge) to arrive at the amount financed of $5,000 + $25 - $50 = $4,975.

Other Calculations

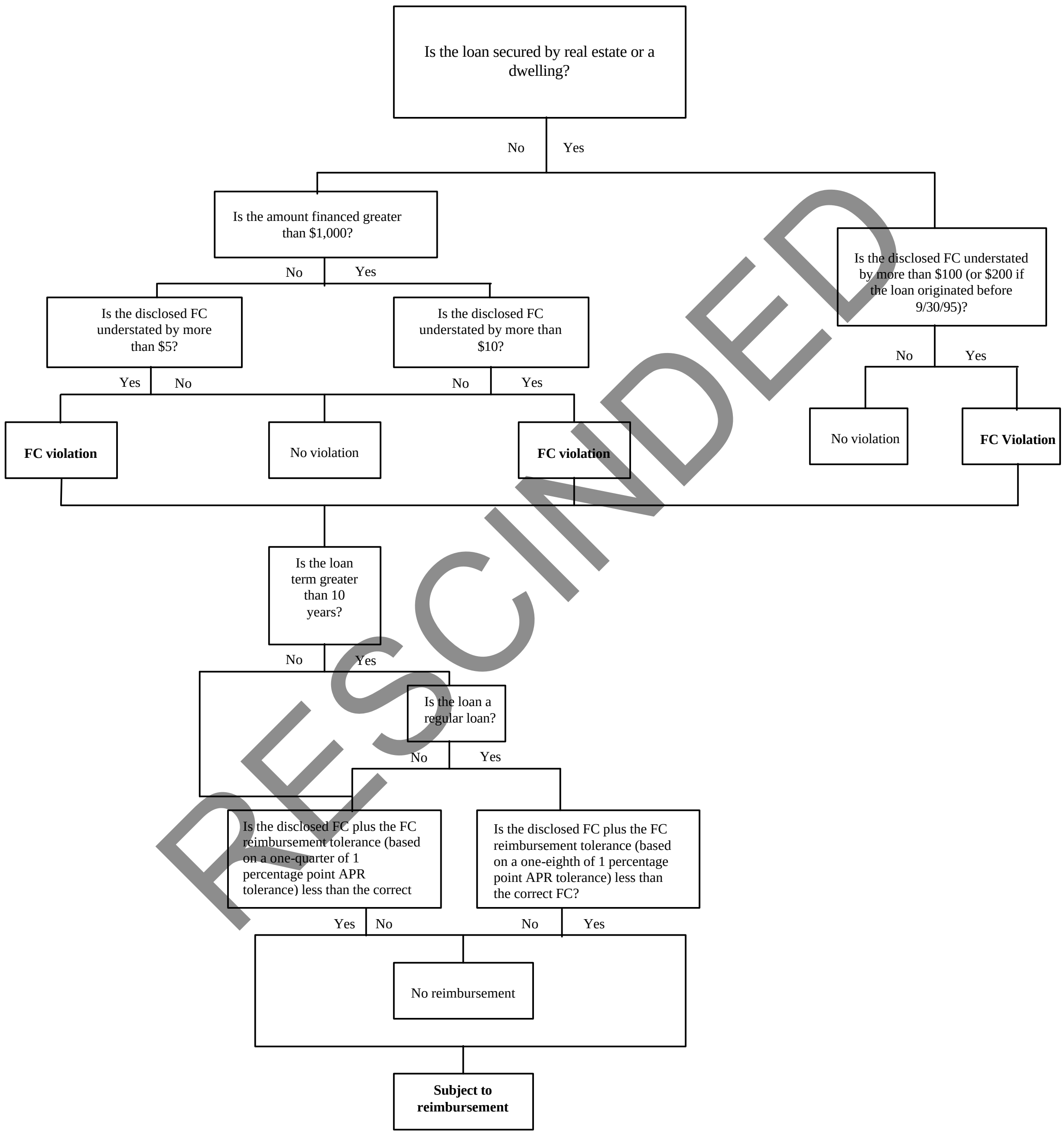
The financial institution may treat the $10 service charge as a prepaid finance charge. If it does, the loan principal would be $5,010. The $5,010 loan principal does not include the $400 precomputed finance charge. The loan principal is increased by other amounts that are financed which are not part of the finance charge (the $25 credit report fee) and reduced by any prepaid finance charges (the $50 loan fee and the $10 service charge withheld from loan proceeds) to arrive at the same amount financed of $5,010 + $25 - $50- $10 = $4,975.

Closed-End Credit: Finance Charge Accuracy Tolerances

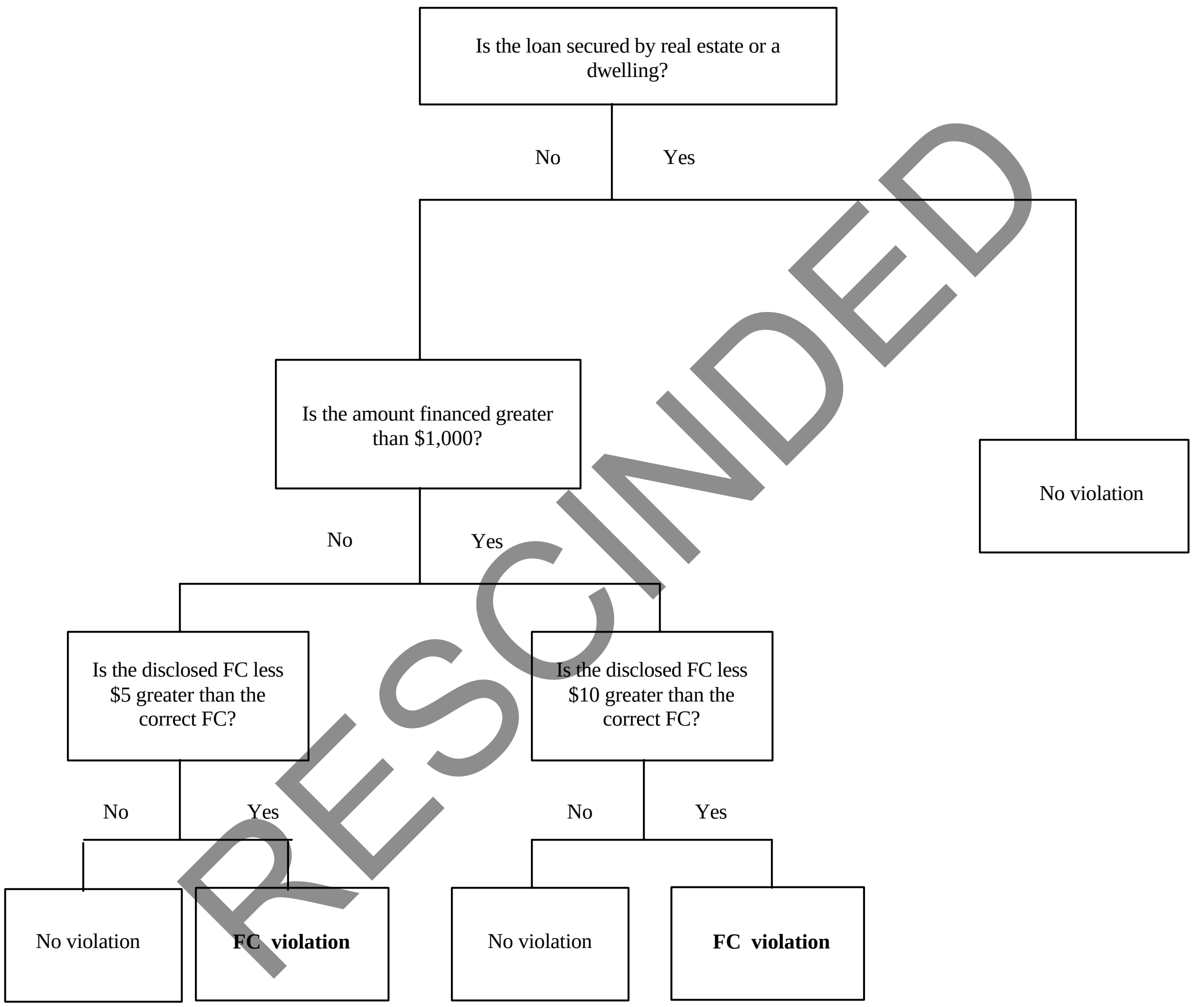


* See 15 USC 160 (aa) and 12 CFR 226.32

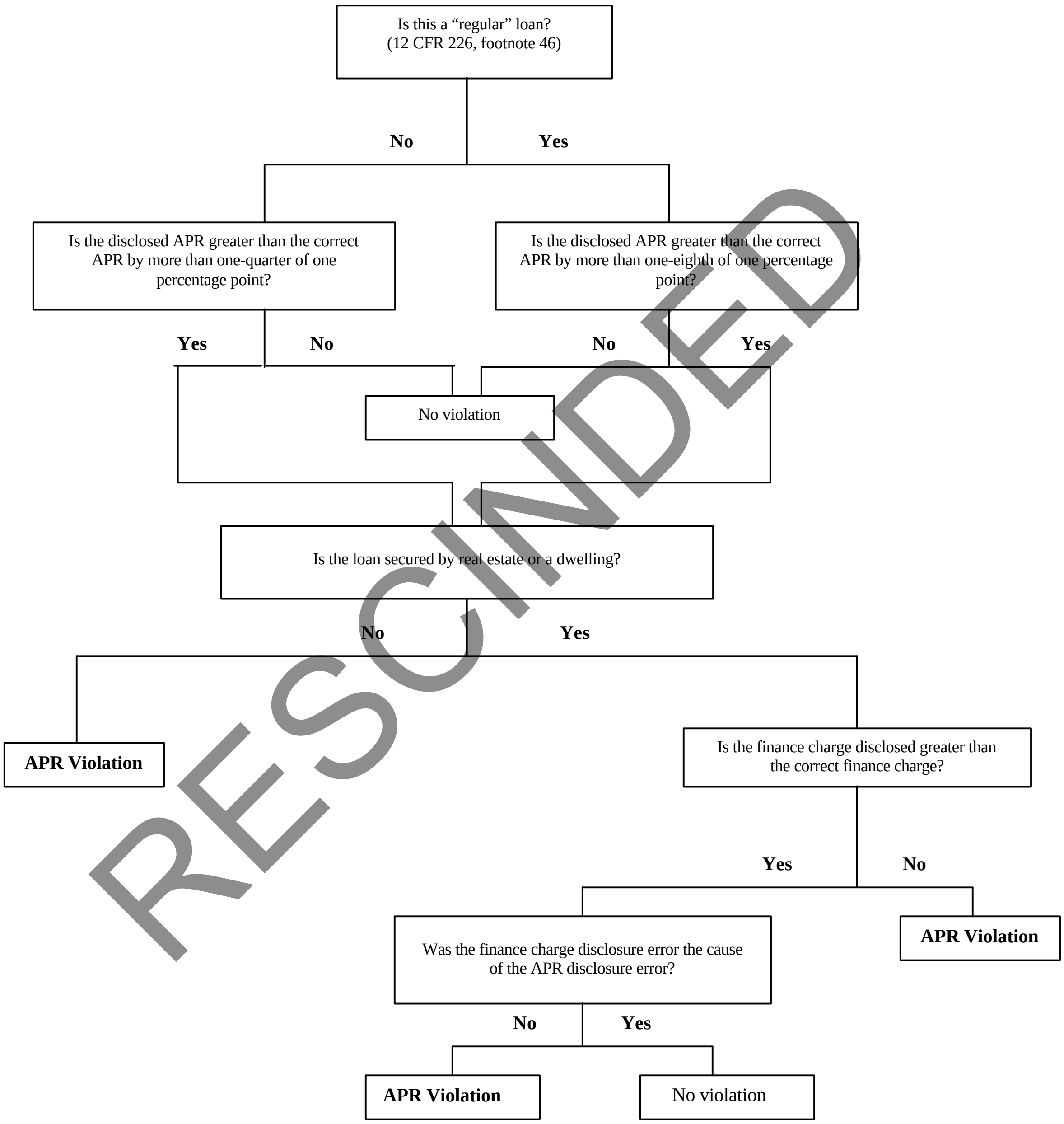
Closed-End Credit: Accuracy and Reimbursement Tolerances for
UNDERSTATED FINANCE CHARGES



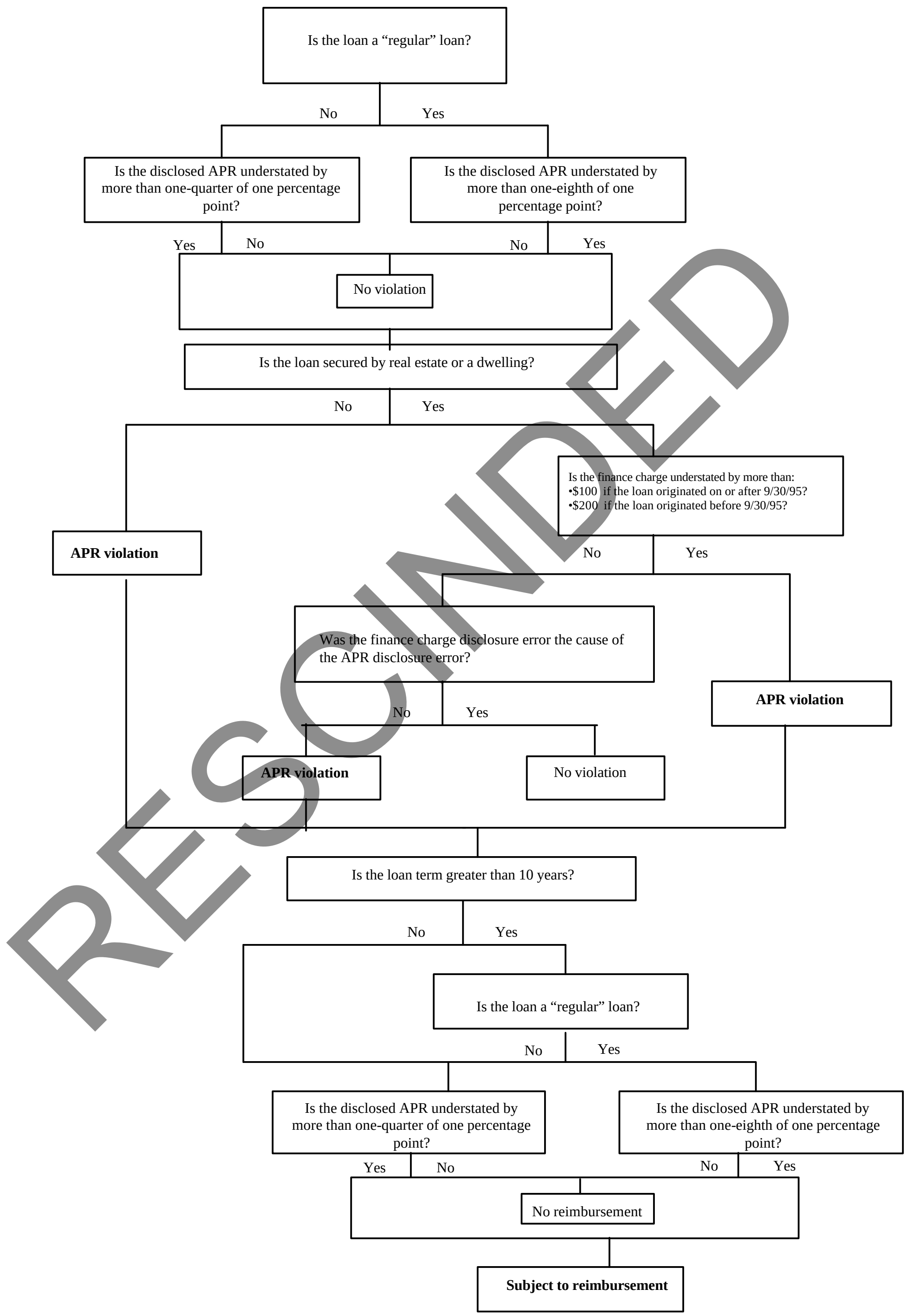
Closed-End Credit: Accuracy Tolerances for **OVERSTATED FINANCE CHARGES**



Closed-End Credit: Accuracy Tolerances for **OVERSTATED APRs**



Closed-End Credit: Accuracy and Reimbursement Tolerances For
UNDERSTATED APRs



Refinancings §226.20

When an obligation is satisfied and replaced by a new obligation to the original financial institution (or a holder or servicer of the original obligation) and is undertaken by the same consumer, it must be treated as a refinancing for which a complete set of new disclosures must be furnished. A refinancing may involve the consolidation of several existing obligations, disbursement of new money to the consumer, or the rescheduling of payments under an existing obligation. In any form, the new obligation must completely replace the earlier one to be considered a refinancing under the regulation. The finance charge on the new disclosure must include any unearned portion of the old finance charge that is not credited to the existing obligation. (§226.20(a))

The following transactions are not considered refinancings even if the existing obligation is satisfied and replaced by a new obligation undertaken by the same consumer:

- A renewal of an obligation with a single payment of principal and interest or with periodic interest payments and a final payment of principal with no change in the original terms.
- An APR reduction with a corresponding change in the payment schedule.
- An agreement involving a court proceeding.
- Changes in credit terms arising from the consumer's default or delinquency.
- The renewal of optional insurance purchased by the consumer and added to an existing transaction, if required disclosures were provided for the initial purchase of the insurance.

However, even if it is not accomplished by the cancellation of the old obligation and substitution of a new one, a new transaction subject to new disclosures results if the financial institution:

- Increases the rate based on a variable rate feature that was not previously disclosed; or
- Adds a variable rate feature to the obligation.

If, at the time a loan is renewed, the rate is increased, the increase is not considered a variable rate feature. It is the cost of renewal, similar to a flat fee, as long as the new rate remains fixed during the remaining life of the loan. If the original debt is not canceled in connection with such a renewal, the regulation does not require new disclosures. Also, changing the index of a variable rate transaction to a comparable index is not considered adding a variable rate feature to the obligation.

Subpart D - Miscellaneous

Civil Liability §130

If a creditor fails to comply with any requirements of the TILA, other than with the advertising provisions of chapter 3, it may be held liable to the consumer for:

- Actual damage, and
- The cost of any legal action together with reasonable attorney's fees in a successful action.

If it violates certain requirements of the TILA, the creditor also may be held liable for either of the following:

- In an individual action, twice the amount of the finance charge involved, but not less than \$100 or more than \$1,000. However, in an individual action relating to a closed-end credit transaction secured by real property or a dwelling, twice the amount of the finance charge involved, but not less than \$200 or more than \$2,000.
- In a class action, such amount as the court may allow. The total amount of recovery, however, cannot be more than \$500,000 or 1 percent of the creditor's net worth, whichever is less.

Civil actions that may be brought against a creditor also may be maintained against any assignee of the creditor if the violation is apparent on the face of the disclosure statement or other documents assigned, except where the assignment was involuntary.

A creditor that fails to comply with TILA's requirements for high-cost mortgage loans may be held liable to the consumer for all finance charges and fees paid to the creditor. Any subsequent assignee is subject to all claims and defenses that the consumer could assert against the creditor, unless the assignee demonstrates that it could not reasonably have determined that the loan was subject to §226.32.

Criminal Liability §112

Anyone who willingly and knowingly fails to comply with any requirement of the TILA will be fined not more than $5,000 or imprisoned not more than one year, or both.

Administrative Actions §108

The TILA authorizes federal regulatory agencies to require financial institutions to make monetary and other adjustments to the consumers' accounts when the true finance charge or APR exceeds the disclosed finance charge or APR by more than a specified accuracy tolerance. That authorization extends to unintentional errors, including isolated violations (e.g., an error that occurred only once or errors, often without a common cause, that occurred infrequently and randomly).

Under certain circumstances, the TILA requires federal regulatory agencies to order financial institutions to reimburse consumers when understatement of the APR or finance charge involves:

- Patterns or practices of violations (e.g., errors that occurred, often with a common cause, consistently or frequently, reflecting a pattern with a specific type or types of consumer credit).
- Gross negligence.
- Willful noncompliance intended to mislead the person to whom the credit was extended.

Any proceeding that may be brought by a regulatory agency against a creditor may be maintained against any assignee of the creditor if the violation is apparent on the face of the disclosure statement or other documents assigned, except where the assignment was involuntary. (§131)

Relationship to State Law §111

State laws providing rights, responsibilities, or procedures for consumers or financial institutions for consumer credit contracts may be:

- Preempted by federal law;
- Appropriate under state law and not preempted by federal law; or
- Substituted in lieu of TILA and Regulation Z requirements.

State law provisions are preempted to the extent that they contradict the requirements in the following chapters of the TILA and the implementing sections of Regulation Z:

- Chapter 1, "General Provisions," which contains definitions and acceptable methods for determining finance charges and annual percentage rates. For example, a state law would be preempted if it required a bank to include in the finance charge any fees that the federal law excludes, such as seller's points.
- Chapter 2, "Credit Transactions," which contains disclosure requirements, rescission rights, and certain credit card provisions. For example, a state law would be preempted if it required a bank to use the terms "nominal annual interest rate" in lieu of "annual percentage rate."
- Chapter 3, "Credit Advertising," which contains consumer credit advertising rules and annual percentage rate oral disclosure requirements.

Conversely, state law provisions may be appropriate and are not preempted under federal law if they call for, without contradicting chapters 1, 2, or 3 of the TILA or the implementing sections of Regulation Z, either of the following:

- Disclosure of information not otherwise required. A state law that requires disclosure of the minimum periodic payment for open-end credit, for example, would not be preempted because it does not contradict federal law.

- Disclosures more detailed than those required. A state law that requires itemization of the amount financed, for example, would not be preempted, unless it contradicts federal law by requiring the itemization to appear with the disclosure of the amount financed in the segregated closed-end credit disclosures.

The relationship between state law and chapter 4 of the TILA ("Credit Billing") involves two parts. The first part is concerned with sections 161 (correction of billing errors) and 162 (regulation of credit reports) of the act; the second part addresses the remaining sections of chapter 4.

State law provisions are preempted if they differ from the rights, responsibilities, or procedures contained in sections 161 or 162. An exception is made, however, for state law that allows a consumer to inquire about an account and requires the bank to respond to such inquiry beyond the time limits provided by federal law. Such a state law would not be preempted for the extra time period.

State law provisions are preempted if they result in violations of sections 163 through 171 of chapter 4. For example, a state law that allows the card issuer to offset the consumer's credit-card indebtedness against funds held by the card issuer would be preempted, since it would violate 12 CFR 226.12(d). Conversely, a state law that requires periodic statements to be sent more than 14 days before the end of a free-ride period would not be preempted, since no violation of federal law is involved.

A bank, state, or other interested party may ask the Federal Reserve Board to determine whether state law contradicts chapters 1 through 3 of the TILA or Regulation Z. They also may ask if the state law is different from, or would result in violations of, chapter 4 of the TILA and the implementing provisions of Regulation Z. If the board determines that a disclosure required by state law (other than a requirement relating to the finance charge, annual percentage rate, or the disclosures required under §226.32) is substantially the same in meaning as a disclosure required under the act or Regulation Z, generally creditors in that state may make the state disclosure in lieu of the federal disclosure.

Subpart E - Special Rules for Certain Home Mortgage Transactions

General Rules §226.31

The requirements and limitations of this subpart are in addition to and not in lieu of those contained in other subparts of Regulation Z. The disclosures for high cost and reverse mortgage transactions must be made clearly and conspicuously in writing, in a form that the consumer may keep.

Certain Closed-End Home Mortgages §226.32

The requirements of this section apply to a consumer credit transaction secured by the consumer's principal dwelling, in which either:

- The APR at consummation will exceed by more than 8 percentage points for first-lien mortgage loans, or by more than 10 percentage points for subordinate-lien mortgage loans, the yield on Treasury securities having comparable periods of maturity to the loan's maturity (as of the 15th day of the month immediately preceding the month in which the application for the extension of credit is received by the creditor); or

- The total points and fees (see definition below) payable by the consumer at or before loan closing will exceed the greater of eight percent of the total loan amount or $480 for the calendar year 2002. (This dollar amount is adjusted annually based on changes in the Consumer Price Index. See staff commentary to 32(a)(1)(ii) for a historical list of dollar amount adjustments.) (§226.32(a)(1))

Exemptions:

- Residential mortgage transactions (generally purchase money mortgages),

- Reverse mortgage transactions subject to §226.33, or

- Open-end credit plans subject to Subpart B of Regulation Z.

***Points and Fees** include the following:*

- All items required to be disclosed under §226.4(a) and (b), except interest or the time-price differential;
- All compensation paid to mortgage brokers; and
- All items listed in §226.4(c)(7), other than amounts held for future taxes, <u>unless all of the following conditions are met</u>:
  - — The charge is reasonable;
  - — The creditor receives no direct or indirect compensation in connection with the charge;
  - — The charge is not paid to an affiliate of the creditor; and
  - — Premiums or other charges, paid at or before closing whether paid in cash or financed, for optional credit life, accident, health, or loss-of-income insurance, and other debt-protection or debt cancellation products written in connection with the credit transaction (§226.32(b)(1)).

Reverse Mortgages §226.33

A reverse mortgage is a non-recourse transaction secured by the consumer's principal dwelling which ties repayment (other than upon default) to the homeowner's death or permanent move from, or transfer of the title of, the home.

Specific Defenses §108

Defense Against Civil, Criminal, and Administrative Actions

A financial institution in violation of TILA may avoid liability by:

- Discovering the error before an action is brought against the financial institution, or before the consumer notifies the financial institution, in writing, of the error.
- Notifying the consumer of the error within 60 days of discovery.
- Making the necessary adjustments to the consumer's account, also within 60 days of discovery. (The consumer will pay no more than the lesser of the finance charge actually disclosed or the dollar equivalent of the APR actually disclosed.)

The above three actions also may allow the financial institution to avoid a regulatory order to reimburse the customer.

An error is "discovered" if it is:

- Discussed in a final, written report of examination.
- Identified through the financial institution's own procedures.
- An inaccurately disclosed APR or finance charge included in a regulatory agency notification to the financial institution.

When a disclosure error occurs, the financial institution is not required to re-disclose after a loan has been consummated or an account has been opened. If the financial institution corrects a disclosure error by merely re-disclosing required information accurately, without adjusting the consumer's account, the financial institution may still be subject to civil liability and an order to reimburse from its regulator.

The circumstances under which a financial institution may avoid liability under the TILA do not apply to violations of the Fair Credit Billing Act (chapter 4 of the TILA).

Additional Defenses Against Civil Actions

The financial institution may avoid liability in a civil action if it shows by a preponderance of evidence that the violation was not intentional and resulted from a bona fide error that occurred despite the maintenance of procedures to avoid the error.

A bona fide error may include a clerical, calculation, computer malfunction, programming, or printing error. It does not include an error of legal judgment.

Showing that a violation occurred unintentionally could be difficult if the financial institution is unable to produce evidence that explicitly indicates it has an internal controls program designed to ensure compliance. The financial institution's demonstrated commitment to compliance and its adoption of policies and procedures to detect errors before disclosures are furnished to consumers could strengthen its defense.

Statute of Limitations §§108 and 130

Civil actions may be brought within one year after the violation occurred. After that time, and if allowed by state law, the consumer may still assert the violation as a defense if a financial institution were to bring an action to collect the consumer's debt.

Criminal actions are not subject to the TILA one-year statute of limitations.

Regulatory administrative enforcement actions also are not subject to the one-year statute of limitations. However, enforcement actions under the policy guide involving erroneously disclosed APRs and finance charges are subject to time limitations by the TILA. Those limitations range from the date of the last regulatory examination of the financial institution, to as far back as 1969, depending on when loans were made, when violations were identified, whether the violations were repeat violations, and other factors.

There is no time limitation on willful violations intended to mislead the consumer. A summary of the various time limitations follows.

- For open-end credit, reimbursement applies to violations not older than two years.
- For closed-end credit, reimbursement is generally directed for loans with violations occurring since the immediately preceding examination.

RESCISSION RIGHTS (Open-End and Closed-End Credit) §226.15 and §226.23

TILA provides that for certain transactions secured by the consumer's principal dwelling, a consumer has three business days after becoming obligated on the debt to rescind the transaction. The right of rescission allows consumer(s) time to reexamine their credit agreements and cost disclosures and to reconsider whether they want to place their homes at risk by offering it/them as security for the credit. Transactions exempt from the right of rescission include residential mortgage transactions (§226.2(a)(24)) and refinancings or consolidations with the original creditor where no "new money" is advanced.

If a transaction is rescindable, consumers must be given a notice explaining that the creditor has a security interest in the consumer's home, that the consumer may rescind, how the consumer may rescind, the effects of rescission, and the date the rescission period expires.

To rescind a transaction, a consumer must notify the creditor in writing by midnight of the third business day after the latest of three events: (1) consummation of the transaction, (2) delivery of material TILA disclosures, or (3) receipt of the required notice of the right to rescind. For purposes of rescission, business day means every calendar day except Sundays and the legal public holidays (§226.2(a)(6)). The term "material disclosures" is defined in §226.23(a)(3) to mean the required disclosures of the annual percentage rate, the finance charge, the amount financed, the total of payments, the payment schedule, and the disclosures and limitations referred to in §226.32(c) and (d).

The creditor may not disburse any monies (except into an escrow account) and may not provide services or materials until the three-day rescission period has elapsed and the creditor is reasonably satisfied that the consumer has not rescinded. If the consumer rescinds the transaction, the creditor must refund all amounts paid by the consumer (even amounts disbursed to third parties) and terminate its security interest in the consumer's home.

A consumer may waive the three-day rescission period and receive immediate access to loan proceeds if the consumer has a “bona fide personal financial emergency.” The consumer must give the creditor a signed and dated waiver statement that describes the emergency, specifically waives the right, and bears the signatures of all consumers entitled to rescind the transaction. The consumer provides the explanation for the bona fide personal financial emergency, but the creditor decides the sufficiency of the emergency.

If the required rescission notice or material TILA disclosures are not delivered or if they are inaccurate, the consumer’s right to rescind may be extended from three days after becoming obligated on a loan to up to three years.

Examination Objectives

1. To appraise the quality of the financial institution’s compliance management system for the Truth in Lending Act and Regulation Z.

2. To determine the reliance that can be placed on the financial institution’s compliance management system, including internal controls and procedures performed by the person(s) responsible for monitoring the financial institution’s compliance review function for the Truth In Lending Act and Regulation Z.

3. To determine the financial institution’s compliance with the Truth In Lending Act and Regulation Z.

4. To initiate corrective action when policies or internal controls are deficient, or when violations of law or regulation are identified.

5. To determine whether the institution will be required to make adjustments to consumer accounts under the restitution provisions of the Act.

General Procedures

1. Obtain information pertinent to the area of examination from the financial institution’s compliance management system program (historical examination findings, complaint information, and significant findings from compliance review and audit).

2. Through discussions with management and review of the following documents, determine whether the financial institution’s internal controls are adequate to ensure compliance in the area under review. Identify procedures used daily to detect errors/violations promptly. Also, review the procedures used to ensure compliance when changes occur (e.g., changes in interest rates, service charges, computation methods, and software programs).

   - ❑ Organizational charts.
   - ❑ Process flowcharts.
   - ❑ Policies and procedures.
   - ❑ Loan documentation and disclosures.
   - ❑ Checklists/worksheets and review documents.
   - ❑ Computer programs.

3. Review compliance review and audit work papers and determine whether:

   a. The procedures used address all regulatory provisions (see Transactional Testing section).

   b. Steps are taken to follow up on previously identified deficiencies.

   c. The procedures used include samples that cover all product types and decision centers.

   d. The work performed is accurate (through a review of some transactions).

   e. Significant deficiencies, and the root cause of the deficiencies, are included in reports to management/board.

   f. Corrective actions are timely and appropriate.

   g. The area is reviewed at an appropriate interval.

Disclosure Forms

4. Determine if the financial institution has changed any preprinted TILA disclosure forms or if there are forms that have not been previously reviewed for accuracy. If so:

   Verify the accuracy of each preprinted disclosure by reviewing the following:

   - Note and/or contract forms (including those furnished to dealers).
   - Standard closed-end credit disclosures (§§226.17(a) and 226.18).
   - ARM disclosures (§226.19(b)).
   - High cost mortgage disclosures (§226.32(c)).
   - Initial disclosures (§226.6(a)-(d)) and, if applicable, additional HELC disclosures (§226.6(e)).
   - Credit card application/solicitation disclosures (§226.5a(b)-(e)).
   - HELC disclosures (§226.5b(d) and (e)).
   - Statement of billing rights and change in terms notice (§226.9(a)).
   - Reverse mortgage disclosures (§226.33(b)).

<u>Closed-End Credit Forms Review Procedures</u>

a. Determine the disclosures are clear, conspicuous, grouped, and segregated. The terms Finance Charge and APR should be more conspicuous than other terms (§226.17(a)).

b. Determine the disclosures include the following as applicable (§226.18).

   1. Identity of the creditor
   2. Brief description of the finance charge
   3. Brief description of the APR
   4. Variable rate verbiage (§226.18(f)(1) or (2)).
   5. Payment schedule
   6. Brief description of the total of payments
   7. Demand feature
   8. Description of total sales price in a credit sale
   9. Prepayment penalty's or rebates
   10. Late payment amount or percentage
   11. Description for security interest
   12. Various insurance verbiage (§226.4(d)).
   13. Statement referring to the contract
   14. Statement regarding assumption of the note
   15. Statement regarding required deposits.

c. Determine all variable rate loans with a maturity greater than one year secured by a principal dwelling are given the following disclosures at the time of application (§226.19).

   1. Consumer handbook on adjustable rate mortgages or substitute
   2. Statement that interest rate payments and or terms can change
   3. The index/formula and a source of information
   4. Explanation of the interest rate/payment determination and margin
   5. Statement that the consumer should ask for the current interest rate and margin
   6. Statement that the interest rate is discounted, if applicable
   7. Frequency of interest rate and payment changes
   8. Rules relating to all changes

9. Either a historical example based on 15 years, or the initial rate and payment with a statement that the periodic payment may substantially increase or decrease together with a maximum interest rate and payment

10. Explanation of how to compute the loan payment, giving an example

11. Demand feature, if applicable

12. Statement of content and timing of adjustment notices

13. Statement that other variable rate loan program disclosures are available, if applicable.

d. Determine that the disclosures required for high-cost mortgage transactions clearly and conspicuously include the items below. [§226.32(c), see Form H-16 in Appendix H.]

1. The required statement "you are not required to complete this agreement merely because you have received these disclosures or have signed a loan application. If you obtain this loan, the lender will have a mortgage on your home. You could lose your home, and any money you have put into it, if you do not meet your obligations under the loan"

2. Annual percentage rate

3. Amount of the regular monthly (or other periodic) payment and the amount of any balloon payment. The regular payment should include amounts for voluntary items, such as credit life insurance or debt-cancellation coverage, only if the consumer has previously agreed to the amount [See staff commentary to 32(c)(3).]

4. Statement that the interest rate may increase, and the amount of the single maximum monthly payment, based on the maximum interest rate allowed under the contract, if applicable.

5. For a mortgage refinancing, the total amount borrowed, as reflected by the face amount of the note; and where the amount borrowed includes premiums or other charges for optional credit insurance or debt-cancellation coverage, that fact shall be stated (grouped together with the amount borrowed).

<u>Open-End Credit Forms Review Procedures</u>

a. Determine the initial disclosure statement is provided before the first transaction under the account and ensure the disclosure includes the items below as applicable (§226.6).

1. Statement of when the finance charge is to accrue and if a grace period exists

2. Statement of periodic rates used and the corresponding APR

3. Explanation of the method of determining the balance on which the finance charge may be computed

4. Explanation of how the finance charge would be determined

5. Statement of the amount of any other charges

6. Statement of creditor's security interest in the property

7. Statement of billing rights (§§226.12 and 226.13)

8. Certain home equity plan information if not provided with the application in a form the consumer could keep. (§226.6(e)(7))

b. Determine the following credit card disclosures were made clearly and conspicuously on or with a solicitation or an application. Disclosures in 12-point type are deemed to comply with the requirements. See staff comment 5a(a)(2)-1. The APR for purchases (other than an introductory rate that is lower than the rate that will apply after the introductory rate expires) must be in at least 18-point type (§226.5a).

1. APR for purchases, cash advances, and balance transfers, including penalty rates that may apply. If the rate is variable, the index or formula, and margin must be identified.
2. Fee for issuance of the card
3. Minimum finance charge
4. Transaction fees
5. Length of the "grace period"
6. Balance computation method
7. Statement that charges incurred by use of the charge card are due when the periodic statement is received.

Note: The above items must be provided in a prominent location in the form of a table. The remaining items may be included in the same table or clearly and conspicuously elsewhere on the same document. An explanation of specific events that may result in the imposition of a penalty rate must be placed outside the table with an asterisk inside the table (or other means) directing the consumer to the additional information.

8. Cash advance fees
9. Late payment fees
10. Fees for exceeding the credit limit

c. Determine that disclosure of items 1-7 in "b" above are made orally for creditor-initiated telephone applications and pre-approved solicitations. Also, determine for applications or solicitations made to the general public that the card issuer makes one of the optional disclosures (§226.5a(d) and (e)).

d. Determine the following home equity disclosures were made clearly and conspicuously, at the time of application (§226.5b).

1. Home equity brochure
2. Statement that the consumer should retain a copy of the disclosure
3. Statement of the time the specific terms are available
4. Statement that terms are subject to change before the plan opens
5. Statement that the consumer may receive a full refund of all fees
6. Statement that the consumer's dwelling secures the credit
7. Statement that the consumer could lose the dwelling
8. Creditors right to change, freeze, or terminate the account
9. Statement that information about conditions for adverse action are available upon request
10. Payment terms including the length of the draw and repayment periods, how the minimum payment is determined, the timing of payments, and an example based on $10,000 and a recent APR
11. A recent APR imposed under the plan and a statement that the rate does not include costs other than interest (fixed rate plans only)
12. Itemization of all fees paid to creditor
13. Estimate of any fees payable to third parties to open the account and a statement that the consumer may receive a good faith itemization of third party fees
14. Statement regarding negative amortization, as applicable
15. Transaction requirements
16. Statement that the consumer should consult a tax advisor regarding the deductibility of interest and charges under the plan

17. For variable rate home equity plans, disclose the following:

    i. That the APR, payment, or term may change

    ii. The APR excludes costs other than interest

    iii. Identify the index and its source

    iv. How the rate will be determined

    v. Statement that the consumer should request information on the current index value, margin, discount, premium, or APR

    vi. Statement that the initial rate is discounted and the duration of the discount, if applicable

    vii. Frequency of APR changes

    viii. Rules relating to changes in the index, APR, and payment amount

    ix. Lifetime rate cap and any annual caps, or a statement that there is no annual limitation

    x. The minimum payment requirement, using the maximum APR, and when the maximum APR may be imposed

    xi. A table, based on a $10,000 balance, reflecting all significant plan terms

    xii. Statement that rate information will be provided on or with each periodic statement.

e. Determine when the last statement of billing rights was furnished to customers and whether the institution used the short form notice with each periodic statement (§226.9(a)).

f. Determine that the notice of any change in terms was provided 15 days prior to the effective date of the change (§226.9(b)).

g. Determine that disclosure of items 1-7 in "b" above are provided if the account is renewed. Additionally, the disclosure provided upon renewal must disclose how and when the cardholder may terminate the credit to avoid paying the renewal fee (§226.9(e)).

h. Determine that a statement of the maximum interest rate that may be imposed during the term of the obligation is made for any loan in which the APR may increase during the plan (§226.30(b)).

<u>Reverse Mortgage Forms Review Procedures (Both open and closed-end)</u>

a. Determine that the disclosures required for reverse mortgage transactions are substantially similar to the model form in Appendix K and include the items below.

    1. A statement that the consumer is not obligated to complete the reverse mortgage transaction merely because he or she has received the disclosures or signed an application

    2. A good faith projection of the total cost of the credit expressed as a table of "total annual loan cost rates" including payments to the consumer, additional creditor compensation, limitations on consumer liability, assumed annual appreciation, and the assumed loan period

    3. An itemization of loan terms, charges, the age of the youngest borrower, and the appraised property value

    4. An explanation of the table of total annual loan costs rates.

    Note: Forms that include or involve current transactions, such as change in terms notices, periodic billing statements, rescission notices, and billing error communications, are verified for accuracy when the file review worksheets are completed.

Timing of Disclosures

5. Review financial institution policies, procedures, and systems to determine, either separately, or when completing the actual file review, whether the applicable disclosures listed below are furnished when required by Regulation Z. Take into account products that have different features, such as closed-end loans or credit card accounts that are fixed or variable rate.

   a. Credit card application and solicitation disclosures - On or with the application (§226.5a(b)).

   b. HELC disclosures – At the time the application is provided or within three business days under certain circumstances (§226.5b(b)).

   c. Open-end credit initial disclosures – Before the first transaction is made under the plan (§226.5(b)(1)).

   d. Periodic disclosures – At the end of a billing cycle if the account has a debit or credit balance of $1 or more or if a finance charge has been imposed (§226.5(b)(2)).

   e. Statement of billing rights – At least once per year (§226.9(a)).

   f. Supplemental credit devices – Before the first transaction under the plan (§226.9(b)).

   g. Open-end credit change in terms – 15 days prior to the effective change date (§226.9(c)).

   h. Finance charge imposed at time of transaction – Prior to imposing any fee (§226.9(d)).

   i. Disclosures upon renewal of credit or charge card – 30 days or one billing cycle, whichever is less before the delivery of the periodic statement on which the renewal fee is charged. Alternatively, notice may be delayed until the mailing or delivery of the periodic statement on which the renewal fee is charged to the accounts if the notice meets certain requirements (§226.9(e)).

   j. Change in credit account insurance provider – Certain information 30 days before the change in provider occurs and certain information 30 days after the change in provider occurs. The institution may provide a combined disclosure 30 days before the change in provider occurs (§226.9(f)).

   k. Closed-end credit disclosures – Before consummation (§226.17(b)).

   l. Disclosures for certain closed-end home mortgages – Three business days prior to consummation (§226.31(c)(1)).

   m. Disclosures for reverse mortgages – Three days prior to consummation of a closed-end credit transaction or prior to the first transaction under an open-end credit plan (§226.31(c)(2)).

   n. Disclosures for adjustable-rate mortgages – At least once each year during which an interest rate adjustment is implemented without an accompanying payment change, and at least 25, but no more than 120 calendar days before a new payment amount is due, or in accordance with other variable-rate subsequent-disclosure regulations issued by a supervisory agency (§226.20(c)).

Record Retention

6. Review the financial institution's record retention practices to determine whether evidence of compliance (for other than the advertising requirements) is retained for at least two years after the disclosures was required to be made or other action was required to be taken (§226.25).

Transactional Testing

Note: When verifying APR accuracies, use the OCC's APR calculation model or other calculation tool acceptable to your regulatory agency.

RESCINDED

Advertising

7. Sample advertising copy, including any Internet advertising, since the previous examination and verify that the terms of credit are specific. If triggering terms are used, determine the required disclosures are made (§§226.16 and 226.24).

   For advertisements for closed-end credit, determine:

   — if a rate of finance charge was stated, that it was stated as an APR

   — if an APR will increase after consummation, a statement to that fact is made

Closed-End Credit

8. For each type of closed-end loan being tested, determine the accuracy of the disclosures by comparing the disclosures to the contract and other financial institution documents (§226.17).

9. Determine whether the required disclosures were made before consummation of the transaction and ensure the presence and accuracy of the items below, as applicable (§226.18).

   a. Amount financed

   b. Itemization of the amount financed (RESPA GFE may substitute)

   c. Finance charge

   d. APR

   e. Variable rate verbiage as follows for loans not secured by a principal dwelling or with terms of one year or less:

      1. Circumstances which permit rate increase

      2. Limitations on the increase (periodic or lifetime)

      3. Effects of the increase

      4. Hypothetical example of new payment terms

   f. Payment schedule including amount, timing and number of payments.

   g. Total of payments.

   h. Total sales price (credit sale)

   i. Description of security interest

   j. Credit life insurance premium included in the finance charge unless:

      — Insurance is not required;

      — Premium for the initial term is disclosed; and

      — Consumer signs or initials an affirmative written request for the insurance.

   k. Property insurance available from the creditor excluded from the finance charge if the premium for the initial term of the insurance is disclosed

   l. Required deposit.

10. Determine for adjustable rate mortgage loans secured by the borrower's principal dwelling with maturities of more than one year that the required early and subsequent disclosures are complete, accurate, and timely. Early disclosures required by §226.19(a) are verified during the closed-end credit forms review. Subsequent disclosures should include the items below, as applicable (§226.20(c)).

    a. Current and prior interest rates

    b. Index values used to determine current and prior interest rates

    c. Extent to which the creditor has foregone an increase in the interest rate

    d. Contractual effects of the adjustment (new payment and loan balance)

    e. Payment required to avoid negative amortization.

Note: The accuracy of the adjusted interest rates and indexes should be verified by comparing them with the contract and early disclosures. Refer to the Additional Variable Rate Testing section of these examination procedures.

11. Determine, for each type of closed-end rescindable loan being tested, two copies of the rescission notice are provided to each person whose ownership interest is or will be subject to the security interest. The rescission notice must disclose the items below (§226.23(b)).

    a. Security interest taken in the consumer's principal dwelling

    b. Consumer's right to rescind the transaction

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

    d. Effects of rescission

    e. Date the rescission period expires.

12. Ensure funding was delayed until the rescission period expired (§226.23(c)).

13. Determine if the institution has waived the three-day right to rescind since the previous examination. If applicable, test rescission waivers (§226.23(e)).

14. Determine whether the maximum interest rate in the contract is disclosed for any adjustable rate consumer credit contract secured by a dwelling (§226.30(a)).

Open-End Credit

15. For each open-end credit product tested, determine the accuracy of the disclosures by comparing the disclosure with the contract and other financial institution documents (§226.5(c)).

16. Review the financial institution's policies, procedures, and practices to determine whether it provides appropriate disclosures for creditor-initiated direct mail applications and solicitations to open charge card accounts, telephone applications and solicitations to open charge card accounts, and applications and solicitations made available to the general public to open charge card accounts (§226.5a(b), (c), and (d)).

17. Determine for all home equity plans with a variable rate that the APR is based on an independent index. Further, ensure home equity plans are terminated or terms changed only if certain conditions exist (§226.5b(f)).

18. Determine that, if any consumer rejected a home equity plan because a disclosed term changed before the plan was opened, all fees were refunded. Verify that non-refundable fees were not imposed until three business days after the consumer received the required disclosures and brochure (§226.5b(g) and (h)).

19. Review consecutive periodic billing statements for each major type of open-end credit activity offered (overdraft and home-equity lines of credit, credit card programs, etc.). Determine whether disclosures were calculated accurately and are consistent with the initial disclosure statement furnished in connection with the accounts (or any subsequent change in terms notice) and the underlying contractual terms governing the plan(s). The periodic statement must disclose the items below, as applicable (§226.7).

    a. Previous balance

    b. Identification of transactions

    c. Dates and amounts of any credits

    d. Periodic rates and corresponding APRs, if variable rate plan, must disclose that the periodic rates may vary

    e. Balance on which the finance charge is computed and an explanation of how the balance is determined

    f. Amount of finance charge with an itemization of each of the components of the finance charge

    g. Annual percentage rate

h. Itemization of other charges

i. Closing date and balance

j. Payment date, if there is a "free ride" period

k. Address for notice of billing errors.

20. Verify the institution credits a payment to the open-end account as of the date of receipt (§226.10).

21. Determine institution's treatment of credit balances. Specifically, if the account's credit balance is in excess of $1, the institution must disclose the items below (§226.11).

    a. Credit the amount to the consumer's account;

    b. Refund any part of the remaining credit balance within seven business days from receiving a written request from the consumer; and

    c. Make a good faith effort to refund the amount of the credit to a deposit account of the consumer if the credit remains for more than six months.

22. Review a sample of billing error resolution files and a sample of consumers who have asserted a claim or defense against the financial institution for a credit card dispute regarding property or services. Verify the following (§§226.12 and 226.13).

    a. Credit cards are issued only upon request

    b. Liability for unauthorized credit card use is limited to $50

    c. Disputed amounts are not reported delinquent unless remaining unpaid after the dispute has been settled

    d. Offsetting credit card indebtedness is prohibited

    e. Errors are resolved within two complete billing cycles.

23. Determine, for each type of open-end rescindable loan being tested, two copies of the rescission notice are provided to each person whose ownership interest is or will be subject to the security interest and perform items 11, 12, and 13 under Closed-End Credit.

Additional Variable Rate Testing

24. Verify that when accounts were opened or loans were consummated that loan contract terms were recorded correctly in the financial institution's calculation systems (e.g., its computer). Determine the accuracy of the following recorded information:

    a. Index value,

    b. Margin and method of calculating rate changes,

    c. Rounding method, and

    d. Adjustment caps (periodic and lifetime).

25. Using a sample of periodic disclosures for open-end variable rate accounts (e.g., home equity accounts) and closed-end rate change notices for adjustable rate mortgage loans:

    a. Compare the rate-change date and rate on the credit obligation to the actual rate-change date and rate imposed.

    b. Determine that the index disclosed and imposed is based on the terms of the contract (example: the weekly average of one-year Treasury constant maturities, taken as of 45 days before the change date) (§§226.7(g) and 226.20(c)(2)).

    c. Determine that the new interest rate is correctly disclosed by adding the correct index value with the margin stated in the note, plus or minus any contractual fractional adjustment (§§226.7(g) and 226.20 (c)(1)).

    d. Determine that the new payment disclosed (§226.20(c)(4)) was based on an interest rate and loan balance in effect at least 25 days before the payment change date (consistent with the contract) (§226.20(c)).

Certain Home Mortgage Transactions

26. Determine whether the financial institution originates consumer credit transactions subject to Subpart E of Regulation Z; specifically, certain closed-end home mortgages (high-cost mortgages (§226.32) and reverse mortgages (§226.33).

27. Examiners may use the attached worksheet as an aid for identifying and reviewing high-cost mortgages.

28. Review both high-cost and reverse mortgages to ensure the following:

    a. Required disclosures are provided to consumers in addition to, not in lieu of, the disclosures contained in other subparts of Regulation Z (§226.31(a)).

    b. Disclosures are clear and conspicuous, in writing, and in a form that the consumer may keep (§226.31(b)).

    c. Disclosures are furnished at least three business days prior to consummation of a mortgage transaction covered by §226.32 or a closed-end reverse mortgage transaction (or at least three business days prior to the first transaction under an open-end reverse mortgage) (§226.31(c)).

    d. Disclosures reflect the terms of the legal obligation between the parties (§226.31(d)).

    e. If the transaction involves more than one creditor, only one creditor shall provide the disclosures. Where the obligation involves multiple consumers, the disclosures may be provided to any consumer who is primarily liable on the obligation. However, for rescindable transactions, the disclosures must be provided to each consumer who has the right to rescind (§226.31(e)).

    f. The APR is accurately calculated and disclosed in accordance with the requirements and within the tolerances allowed in §226.22 (§226.31(g)).

29. For high-cost mortgages (§226.32), ensure that:

    b. In addition to other required disclosures, the creditor discloses the following at least three business days prior to consummation: [See model disclosure at App. H-16]

        1. Notice containing the prescribed language (§226.32(c)(1)).

        2. Annual percentage rate (§226.32(c)(2)).

        3. Amount of regular loan payment and the amount of any balloon payment (§226.32(c)(3)).

        4. For variable rate loans, a statement that the interest rate and monthly payment may increase, and the amount of the single maximum monthly payment allowed under the contract (§226.32(c)(4)).

        5. For a mortgage refinancing, the total amount the consumer will borrow (the face amount) and if this amount includes premiums or other charges for optional credit insurance or debt-cancellation coverage, that fact is stated. This disclosure shall be treated as accurate if within $100 (§226.32(c)(5)).

        6. A new disclosure is required if, subsequent to providing the additional disclosure but prior to consummation, there are changes in any terms that make the disclosures inaccurate. For example, if a consumer purchases optional credit insurance and, as a result, the monthly payment differs from the payment previously disclosed, redisclosure is required and a new three-day waiting period applies (§226.31(c)(1)(i)).

        7. If a creditor provides new disclosures by telephone when the consumer

initiates a change in terms, then at consummation: (§226.31(c)(1)(ii))

— The creditor must provide new written disclosures and both parties must sign a statement that these new disclosures were provided by telephone at least three days prior to consummation.

8. If a consumer waives the right to a three-day waiting period to meet a bona fide personal financial emergency, the consumer's waiver must be a dated written statement (not a pre-printed form) describing the emergency and bearing the signature of all entitled to the waiting period (a consumer can waive only after receiving the required disclosures and prior to consummation) (§226.31(c)(1)(iii)).

c. High-cost mortgage transactions do not provide for any of the following loan terms:

1. Balloon payment (if term is less than 5 years, with exceptions) (§226.32(d)(1)(i) and (ii)).

2. Negative amortization (§226.32(d)(2)).

3. Advance payments from the proceeds of more than 2 periodic payments (§226.32(d)(3)).

4. Increased interest rate after default (§226.32(d)(4)).

5. A rebate of interest, arising from a loan acceleration due to default, calculated by a method less favorable than the actuarial method (§226.32(d)(5)).

6. Prepayment penalties (but permitted in the first five years if certain conditions are met) (§226.32(d)(6) and (7)).

7. A due-on-demand clause permitting the creditor to terminate the loan in advance of maturity and accelerate the balance, with certain exceptions (§226.32(d)(8)).

d. The creditor is not engaged in the following acts and practices for high-cost mortgages:

1. Home improvement contracts – paying a contractor under a home improvement contract from the proceeds of a mortgage unless certain conditions are met (§226.34(a)(1)).

2. Notice to assignee – selling or otherwise assigning a high-cost mortgage without furnishing the required statement to the purchaser or assignee (§226.34(a)(2)).

3. Refinancing within one year of extending credit – within one year of making a high-cost mortgage loan, a creditor may not refinance any high-cost mortgage loan to the same borrower into another high-cost mortgage loan that is not in the borrower's interest. This also applies to assignees that hold or service the high-cost mortgage loan. Commentary to 34(a)(3) has examples applying the refinancing prohibition and addressing "borrower's interest" (§226.34(a)(3)).

4. Consumers' ability to repay – engaging in a pattern or practice of extending high-cost mortgages based on the consumer's collateral without regard to repayment ability, including the consumer's current and expected income, current obligations, and employment. A violation is presumed if there is a pattern or practice of making such mortgage loans without verifying and documenting consumers' repayment ability.

A. A creditor may consider any expected income of the consumer, including:

i. Regular salary or wages;

ii. Gifts;

iii. Expected retirement payments; and

iv. Income from self-employment.

B. Equity income that would be realized from the collateral may not be considered.

C. Creditors may verify and document a consumer's income and obligations through any reliable source that provides the creditor with a reasonable basis for believing that there are sufficient funds to support the loan. Reliable sources include:

i. Credit reports;

ii. Tax return;

iii. Pension statements; or

iv. Payment records for employment income.

D. If a loan transaction includes a discounted introductory rate, the creditor must consider the consumer's ability to repay based on the non-discounted or fully indexed rate.

Commentary to 34(a)(4) contains guidance on income that may be considered, on "pattern or practice," and on "verifying and documenting" income and obligations (§226.34(a)(4)).

30. Ensure that the creditor does not structure a home-secured loan as an open-end plan ("spurious open-end credit") to evade the requirements of Regulation Z. See staff commentary to 34(b) for factors to be considered (§226.34(b)).

Administrative Enforcement

31. If there is noncompliance involving understated finance charges or understated APRs subject to reimbursement under the FFIEC Policy Guide on Reimbursement (policy guide), continue with step 32.

32. Document the date on which the administrative enforcement of the TILA policy statement would apply for reimbursement purposes by determining the date of the preceding examination.

33. If the noncompliance involves indirect (third-party paper) disclosure errors and affected consumers have not been reimbursed:

a. Prepare comments, discussing the need for improved internal controls to be included in the report of examination.

b. Notify your supervisory office for follow up with the regulator that has primary responsibility for the original creditor.

If the noncompliance involves direct credit:

c. Make an initial determination whether the violation is a pattern or practice.

d. Calculate the reimbursement for the loans or accounts in an expanded sample of the identified population.

e. Estimate the total impact on the population based on the expanded sample.

f. Inform management that reimbursement may be necessary under the law and the policy guide, and discuss all substantive facts including the sample loans and calculations.

g. Inform management of the financial institution's options under section 130 of the TILA for avoiding civil liability and of its option under the policy guide and section 108 (e)(6) of the TILA for avoiding a regulatory agency's order to reimburse affected borrowers.

HIGH-COST MORTGAGE (§226.32) WORKSHEET

Borrower's Name	Loan Number:

COVERAGE		
	Yes	**No**
Is the loan secured by the consumer's principal dwelling? [§226.2(a)(19), §226.32(a)(1)]		
If the answer is No, STOP HERE		
Is the loan for the following purpose?		
1. Residential Mortgage Transaction – [§226.2(a)(24)]		
2. Reverse Mortgage Transaction – [§226.33]		
3. Open-End Credit Plan – Subpart B [note prohibition against structuring loans as open-end plans to evade §226.32 – [§226.34(b)]		
If the answer is Yes to Box 1, 2, or 3, STOP HERE. If No, continue to Test 1.		

TEST 1 – CALCULATION OF APR		
A. Disclosed APR		
B. Treasury Security Yield of Comparable Maturity Obtain the Treasury Constant Maturities Yield from the FRB's Statistical Release, H-15 – Selected Interest Rates (the "Business" links will display daily yields). Use the yield that has the most comparable maturity to the loan term and is from the 15th day of the month that immediately precedes the month of the application. If the 15th is not a business day, use the yield for the business day immediately preceding the 15th. If the loan term is exactly halfway between two published security maturities, use the lower of the two yields.) Note: Creditors may use the FRB's Selected Interest Rates or the actual auction results. See Staff Commentary to Regulation Z for further details. [§226.32(a)(1)(i)] http://www.federalreserve.gov/releases/H15/data.htm		
C. Treasury Security Yield of Comparable Maturity (Box B) Plus: 8 percentage points for first-lien loan; or 10 percentage points for subordinate-lien loan		
	Yes	**No**
D. Is Box A greater than Box C?		
If Yes, the transaction is a High-Cost Mortgage. If No, continue to Test 2, Points and Fees.		

HIGH-COST MORTGAGE (§226.32) WORKSHEET

TEST 2 – CALCULATION OF POINTS AND FEES		
STEP 1: Identify all Charges Paid by the Consumer at or before Loan Closing		
A. Finance Charges – §226.4(a) and (b) (Interest, including per-diem interest, and time price differential are excluded from these amounts.)		
	Fee	**Subtotals**
Loan Points		
Mortgage Broker Fee		
Loan Service Fees		
Required Closing Agent/3rd Party Fees		
Required Credit Insurance		
Private Mortgage Insurance		
Life of Loan Charges (flood, taxes, etc.)		
Any Other Fees Considered Finance Charges		
Subtotal		
B. Certain Non-Finance Charges Under §226.4(c)(7) – Include fees paid by consumers <u>only</u> if the amount of the fee is unreasonable or if the creditor receives direct or indirect compensation from the charge or the charge is paid to an affiliate of the bank. (See the example in §226.32(b)(1)(ii) of the commentary for further explanation.)		
Title Examination		
Title Insurance		
Property Survey		
Document Preparation Charge		
Credit Report		
Appraisal		
Fee for "Initial" Flood Hazard Determination		
Pest Inspection		
Any Other Fees Not Considered Finance Charges		
Subtotal		
C. Premiums or Other Charges for Optional Credit Life, Accident, Health, or Loss-of-Income Insurance, or Debt-Cancellation Coverage		
D. Total Points & Fees: Add Subtotals for A, B, C		

HIGH-COST MORTGAGE (§226.32) WORKSHEET

TEST 2 – CALCULATION OF POINTS AND FEES (continued)	
STEP 2: Determine the Total Loan Amount for Cost Calculation [226.32(a)(1)(ii)]	
A. Determine the Amount Financed [§226.18(b)] Principal Loan Amount	
Plus: Other Amounts Financed by the Lender *(not already included in the principal and not part of the finance charge)*	
Less: Prepaid Finance Charges [§226.2(a)(23)]	
Equals: Amount Financed	
B. Deduct costs included in the points and fees under §226.32(b)(1)(iii) and (iv) (Step 1, Box B and Box C) that are financed by the creditor	
C. Total Loan Amount (Step 2, Box A minus Box B)	

TEST 2 – CALCULATION OF POINTS AND FEES (continued)		
STEP 3: Perform High-Fee Cost Calculation		
A. Eight Percent of the Total Loan Amount (Step 2, Box C)		
B. Annual Adjustment Amount – [§226.32(a)(1)(ii)] *1999: $441; 2000: $451; 2001: $465; 2002: $480* *(use the dollar amount corresponding to the year of the loan's origination)*		
C. Total Points & Fees (Step 1, Box D)		
	Yes	**No**
In Step 3, does Box C exceed the greater of Box A or Box B?		
If Yes, the transaction is a High-Cost Mortgage. If No, the transaction is not a High-Cost Mortgage under Test 2, Points and Fees.		

I. Background

The Homeowners Protection Act of 1998 (the Act) was signed into law on July 29, 1998, and became effective on July 29, 1999. The Act was amended on December 27, 2000 to provide technical corrections and clarification. The Act, also known as the "PMI Cancellation Act," addresses homeowners' difficulties in canceling private mortgage insurance (PMI)[1] coverage. It establishes provisions for canceling and terminating PMI, establishes disclosure and notification requirements, and requires the return of unearned premiums.

PMI is insurance that protects lenders from the risk of default and foreclosure. PMI allows prospective buyers who cannot, or choose not to, provide significant down payments to obtain mortgage financing at affordable rates. It is used extensively to facilitate "high-ratio" loans (generally, loans in which the loan to value (LTV) ratio exceeds 80 percent). With PMI, the lender can recover costs associated with the resale of foreclosed property, and accrued interest payments or fixed costs, such as taxes or insurance policies, paid prior to resale.

Excessive PMI coverage provides little extra protection for a lender and does not benefit the borrower. In some instances, homeowners have experienced problems in canceling PMI. At other times, lenders may have agreed to terminate coverage when the borrower's equity reached 20 percent, but the policies and procedures used for canceling or terminating PMI coverage varied widely among lenders. Prior to the Act, homeowners had limited recourse when lenders refused

refused

to cancel their PMI coverage. Even homeowners in the few states that had laws pertaining to PMI cancellation or termination noted difficulties in canceling or terminating their PMI policies. The Act now protects homeowners by prohibiting life of loan PMI coverage for borrower-paid PMI products and establishing uniform procedures for the cancellation and termination of PMI policies.

II. Scope and Effective Date

The Act applies primarily to "residential mortgage transactions," defined as mortgage loan transactions consummated on or after July 29, 1999, to finance the acquisition, initial construction or refinancing[2] of a single-family dwelling that serves as a borrower's principal residence.[3] The Act also includes provisions for annual written disclosures for "residential mortgages," defined as mortgages, loans or other evidences of a security interest created for a single-family dwelling that is the principal residence of the borrower (12 USC 4901(14) and (15)). A condominium, townhouse, cooperative or mobile home is considered to be a single-family dwelling covered by the Act.

The Act's requirements vary depending on whether a mortgage is:

- A "residential mortgage" or a "residential mortgage transaction";
- Defined as high risk (either by the lender in the case of nonconforming loans, or Fannie Mae

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[1] The Act does not apply to mortgage insurance made available under the National Housing Act, title 38 of the United States Code, or title V of the Housing Act of 1949. This includes mortgage insurance on loans made by the Federal Housing Administration and guarantees on mortgage loans made by the Veterans Administration.

[2] For purposes of these procedures, "refinancing" means the refinancing of loans any portion of which was to provide financing for the acquisition or initial construction of a single-family dwelling that serves as a borrower's principal residence. *See* 15 USCC 1601 <u>et. seq</u>. and 12 CFR 226.20.

[3] For purposes of these procedures, junior mortgages that provide financing for the acquisition, initial construction or refinancing of a single-family dwelling that serves as a borrower's primary residence are covered.

and Freddie Mac in the case of conforming loans);

- Financed under a fixed rate or an adjustable rate; or
- Covered by borrower-paid private mortgage insurance (BPMI) or lender-paid private mortgage insurance (LPMI).[4]

III. Cancellation and Termination of PMI for Non-High Risk Residential Mortgage Transactions

A. Borrower Requested Cancellation

A borrower may initiate cancellation of PMI coverage by submitting a written request to the servicer. The servicer must take action to cancel PMI when the cancellation date occurs, which is when the principal balance of the loan reaches (based on actual payments) or is first scheduled to reach 80 percent of the "original value,"[5] irrespective of the outstanding balance, based upon the initial amortization schedule (in the case of a fixed rate loan) or amortization schedule then in effect (in the case of an adjustable rate loan),[6] or any date thereafter that:

- the borrower submits a written cancellation request;
- the borrower has a good payment history;[7]
- the borrower is current;[8] and
- the borrower satisfies any requirement of the mortgage holder for: (i) evidence of a type established in advance that the value of the property has not declined below the original value; and (ii) certification that the borrower's equity in the property is not subject to a subordinate lien (12 USC 4902(a)(4)).

Once PMI is canceled, the servicer may not require further PMI payments or premiums more than 30 days after the later of: (i) the date on which the written request was received or (ii) the date on which the borrower satisfied the evidence and certification requirements of the mortgage holder described previously (12 USC 4902(e)(1)).

B. Automatic Termination

The Act requires a servicer to automatically terminate PMI for residential mortgage transactions on the date that:

- the principal balance of the mortgage is first scheduled to reach 78 percent of the original value of the secured property (based solely on the initial amortization schedule in the case of a fixed rate loan or on the amortization schedule then in effect in the case of an adjustable rate loan, irrespective of the outstanding balance) if the borrower is current; or
- if the borrower is not current on that date, on the first day of the first month following the date that the borrower becomes current (12 USC 4902(b)).

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[4] All sections of these procedures and manual apply to BPMI. For LPMI, relevant sections begin under that heading the follow thereafter.

[5] "Original value" is defined as the lesser of the sales price of the secured property as reflected in the purchase contract or, the appraised value at the time of loan consummation. In the case of a refinancing, the term means the appraised value relied upon by the lender to approve the refinance transaction.

[6] The Act includes as an adjustable rate mortgage, a balloon loan that "contains a conditional right to refinance or modify the unamortized principal at the maturity date." Therefore, if a balloon loan contains a conditional right to refinance, the initial disclosure for an adjustable rate mortgage would be used even if the interest rate is fixed.

[7] A borrower has a good payment history if the borrower: (1) has not made a payment that was 60 days or more past due within the first 12 months of the last 2 years prior to the later of the cancellation date, or the date that the borrower request cancellation; or (2) has not made a payment that was 30 days or more past due within the 12 months prior to the later of the cancellation date or the date that the borrower requests cancellation.

[8] The Act does not define current.

If PMI is terminated, the servicer may not require further payments or premiums of PMI more than 30 days after the termination date or the date following the termination date on which the borrower becomes current on the payments, whichever is sooner (12 USC 4902(e)(2)).

There is no provision in the automatic termination section of the Act, as there is with the borrower-requested PMI cancellation section, that protects the lender against declines in property value or subordinate liens. The automatic termination provisions make no reference to good payment history (as prescribed in the borrower-requested provisions), but state only that the borrower must be *current* on mortgage payments (12 USC 4902(b)).

C. Final Termination

If PMI coverage on a residential mortgage transaction was not canceled at the borrower's request or by the automatic termination provision, the servicer must terminate PMI coverage by the first day of the month immediately following the date that is the midpoint of the loan's amortization period if, on that date, the borrower is current on the payments required by the terms of the mortgage. (If the borrower is not current on that date, PMI should be terminated when the borrower does become current).

The midpoint of the amortization period is halfway through the period between the first day of the amortization period established at consummation and ending when the mortgage is scheduled to be amortized. The servicer may not require further payments or premiums of PMI more than 30 days after PMI is terminated (12 USC 4902(e)(3)).

D. Loan Modifications

If a borrower and mortgage holder agree to modify the terms and conditions of a loan pursuant to a residential mortgage transaction, the cancellation, termination or final termination dates shall be recalculated to reflect the modification (12 USC 4902(d)).

E. Exclusions

The Act's cancellation and termination provisions do not apply to residential mortgage transactions for which Lender Paid Mortgage Insurance (LPMI) is required (12 USC 4905(b).

F. Return of Unearned Premiums

The servicer must return all unearned PMI premiums to the borrower within 45 days after cancellation or termination of PMI coverage. Within 30 days after notification by the servicer of cancellation or termination of PMI coverage, a mortgage insurer must return to the servicer any amount of unearned premiums it is holding to permit the servicer to return such premiums to the borrower (12 USC 4902(f)).

G. Accrued Obligations for Premium Payments

The cancellation or termination of PMI does not affect the rights of any lender, servicer or mortgage insurer to enforce any obligation of a borrower for payments of premiums that accrued before the cancellation or termination occurred (12 USC 4902 (h)).

IV. Exceptions to Cancellation and Termination Provisions for High Risk Residential Mortgage Transactions

The borrower-requested cancellation at 80 percent LTV and the automatic termination at 78 percent LTV requirements of the Act do not apply to "high risk" loans. However, high risk loans are subject to final termination and are divided into two categories - conforming (Fannie Mae/Freddie Mac-defined high-risk loans) and nonconforming (lender-defined high-risk loans) (12 USC 4902(g)(1)).

A. Conforming Loans (Fannie Mae/Freddie Mac-Defined High Risk Loans)

Conforming loans are those loans with an original principal balance not exceeding Freddie Mac's and

Fannie Mae's conforming loan limits.[9] Fannie Mae and Freddie Mac are authorized under the Act to establish a category of residential mortgage transactions that are not subject to the Act's requirements for borrower-requested cancellation or automatic termination, because of the high risk associated with them.[10] They are, however, subject to the final termination provision of the Act. As such, PMI on a conforming high risk loan must be terminated by the first day of the month following the date that is the midpoint of the loan's initial amortization schedule (in the case of a fixed rate loan) or amortization schedule then in effect (in the case of an adjustable rate loan) if, on that date, the borrower is current on the loan. (If the borrower is not current on that date, PMI should be terminated when the borrower does become current.)

B. Nonconforming Loans (Lender-Defined High Risk Loans)

Nonconforming loans are those residential mortgage transactions that have an original principal balance exceeding Freddie Mac's and Fannie Mae's conforming loan limits. Lender-defined high risk loans are not subject to the Act's requirements for borrower-requested cancellation or automatic termination. However, if a residential mortgage transaction is a lender-defined high risk loan, PMI must be terminated on the date on which the principal balance of the mortgage, based solely on the initial amortization schedule (in the case of a fixed rate loan) or the amortization schedule then in effect (in the case of an adjustable rate loan) for that mortgage and irrespective of the outstanding balance for that mortgage on that date, is first scheduled to reach 77 percent of the original value of the property securing the loan.

Like conforming loans that are determined to be high risk by Freddie Mac and Fannie Mae, a residential mortgage transaction that is a lender-defined high risk loan is subject to the final termination provision of the Act.

[9] The limit was $322,700 in 2003.

[10] Fannie Mae and Freddie Mac have not defined high-risk loans as of the date of this publication.

C. Notices

The lender must provide written initial disclosures at consummation for all high-risk residential mortgage transactions (as defined by the lender or Fannie Mae or Freddie Mac), that in no case will PMI be required beyond the midpoint of the amortization period of the loan, if the loan is current. More specific notice as to the 77 percent LTV termination standards for lender defined high-risk loans is not required under the Act.

V. Basic Disclosure and Notice Requirements Applicable to Residential Mortgage Transactions and Residential Mortgages

The Act requires the lender in a residential mortgage transaction to provide to the borrower, at the time of consummation, certain disclosures that describe the borrower's rights for PMI cancellation and termination. A borrower may not be charged for any disclosure required by the Act. Initial disclosures vary, based upon whether the transaction is a fixed rate mortgage, adjustable rate mortgage or high-risk loan. The Act also requires that the borrower be provided with certain annual and other notices concerning PMI cancellation and termination. Residential mortgages are subject to certain annual disclosure requirements.

A. Initial Disclosures for Fixed Rate Residential Mortgage Transactions

When PMI is required for non-high risk fixed rate mortgages, the lender must provide to the borrower at the time the transaction is consummated: (i) a written initial amortization schedule, and (ii) a written notice that discloses:

- The borrower's right to request cancellation of PMI, and, based on the initial amortization schedule, the date the loan balance is scheduled to reach 80 percent of the original value of the property;
- The borrower's right to request cancellation on an earlier date, if actual payments bring the loan balance to 80 percent of the original value

of the property sooner than the date based on the initial amortization schedule;

- That PMI will automatically terminate when the LTV ratio reaches 78 percent of the original value of the property and the specific date that is projected to occur (based on the initial amortization schedule); and
- The Act provides for exemptions to the cancellation and automatic termination provisions for high-risk mortgages and whether these exemptions apply to the borrower's loan (12 USC 4903(a)(1)(A)).

B. Initial Disclosures for Adjustable Rate Residential Mortgage Transactions

When PMI is required for non-high risk adjustable rate mortgages, the lender must provide to the borrower, at the time the transaction is consummated, a written notice that discloses:

- The borrower's right to request cancellation of PMI on (i) the date the loan balance is first scheduled to reach 80 percent of the original value of the property based on the amortization schedule then in effect or (ii) the date the balance actually reaches 80 percent of the original value of the property based on actual payments. The notice must also state that the servicer will notify the borrower when either (i) or (ii) occurs;
- That PMI will automatically terminate when the loan balance is first scheduled to reach 78 percent of the original value of the property based on the amortization schedule then in effect. The notice must also state that the borrower will be notified when PMI is terminated (or that termination will occur when the borrower becomes current on payments); and
- That there are exemptions to the cancellation and automatic termination provisions for high risk mortgages and whether such exemptions apply to the borrower's loan (12 USC 4903(a)(1(B)).

C. Initial Disclosures for High Risk Residential Mortgage Transactions

When PMI is required for high risk residential mortgage transactions, the lender must provide to the borrower a written notice stating that PMI will not be required beyond the date that is the midpoint of the loan's amortization period if, on that date, the borrower is current on the payments as required by the terms of the loan. The lender must provide this notice at consummation. The lender need not provide disclosure of the termination at 77 percent LTV for lender defined high risk mortgages (12 USC 4903(a)(2)).

D. Annual Disclosures for Residential Mortgage Transactions

For all residential mortgage transactions, including high risk mortgages for which PMI is required, the servicer must provide the borrower with an annual written statement that sets forth the rights of the borrower to PMI cancellation and termination and the address and telephone number that the borrower may use to contact the servicer to determine whether the borrower may cancel PMI (12 USC 4903(a)(3)).

E. Disclosures for Existing Residential Mortgages

When PMI was required for a residential mortgage consummated before July 29, 1999, the servicer must provide to the borrower an annual written statement that:

- States that PMI may be canceled with the consent of the lender or in accordance with state law; and
- Provides the servicer's address and telephone number, so that the borrower may contact the servicer to determine whether the borrower may cancel PMI (12 USC 4903(b)).

VI. Notification Upon Cancellation or Termination of PMI Relating to Residential Mortgage Transactions

A. General

The servicer must, not later than 30 days after PMI relating to a residential mortgage transaction is cancelled or terminated, notify the borrower in writing that:[11]

- PMI has terminated and the borrower no longer has PMI; and
- No further premiums, payments or other fees are due or payable by the borrower in connection with PMI (12 USC 4904(a)).

B. Notice of Grounds/Timing

If a servicer determines that a borrower in a residential mortgage transaction does not qualify for PMI cancellation or automatic termination, the servicer must provide the borrower with a written notice of the grounds relied on for that determination. If an appraisal was used in making the determination, the servicer must give the appraisal results to the borrower. If a borrower does not qualify for cancellation, the notice must be provided not later than 30 days following the later of: (i) the date the borrower's request for cancellation is received; or (ii) the date on which the borrower satisfies any evidence and certification requirements of the mortgage holder. If the borrower does not meet the requirements for automatic termination, the notice must be provided not later than 30 days following the scheduled termination date (12 USC 4904(b)).

[11] For adjustable rate mortgages, the initial notice to borrowers must state that the servicer will notify the borrower when the cancellation and automatic termination dates are reached (12 USC 4903(a)(1)(B)). Servicers should take care that the appropriate notices are made to borrowers when those dates are reached.

VII. Disclosure Requirements for Lender Paid Mortgage Insurance

A. Definitions

Borrower paid mortgage insurance (BPMI) means PMI that is required for a residential mortgage transaction, the payments for which are made by the borrower.

Lender paid mortgage insurance (LPMI) means PMI that is required for a residential mortgage transaction, the payments for which are made by a person other than the borrower.

Loan commitment means a prospective lender's written confirmation of its approval, including any applicable closing conditions, of the application of a prospective borrower for a residential mortgage loan (12 USC 4905(a)).

B. Initial Notice

In the case of LPMI required for a residential mortgage transaction, the Act requires that the lender provide a written notice to the borrower not later than the date on which a loan ***commitment*** is made. The written notice must advise the borrower of the differences between LPMI and BPMI by notifying the borrower that LPMI:

- Differs from BPMI because it cannot be cancelled by the borrower or automatically terminated as provided under the Act;
- Usually results in a mortgage having a higher interest rate than it would in the case of BPMI; and
- Terminates only when the mortgage is refinanced, (as that term is defined in the Truth in Lending Act, 15 USC 1601 et seq., and Regulation Z, 12 CFR 226.20), paid off, or otherwise terminated.

The notice must also provide:

- That LPMI and BPMI have both benefits and disadvantages;

- A generic analysis of the costs and benefits of a mortgage in the case of LPMI versus BPMI over a ten-year period, assuming prevailing interest and property appreciation rates; and
- That LPMI may be tax-deductible for federal income taxes, if the borrower itemizes expenses for that purpose (12 USC 4905(c)(1)).

C. Notice at Termination Date

Not later than 30 days after the termination date that would apply in the case of BPMI, the servicer shall provide to the borrower a written notice indicating that the borrower may wish to review financing options that could eliminate the requirement for LPMI in connection with the mortgage (12 USC 4905(c)(2)).

VIII. Fees for Disclosures

As stated previously, no fee or other cost may be imposed on a borrower for the disclosures or notifications required to be given to a borrower by lenders or servicers under the Act (12 USC 4906).

IX. Civil Liability

A. Liability Dependent Upon Type of Action

Servicers, lenders and mortgage insurers that violate the Act are liable to borrowers as follows:

- *Individual Action*

  In the case of individual borrowers:

  — Actual damages (including interest accruing on such damages);

  — Statutory damages not to exceed $2,000;

  — Costs of the action; and

  — Reasonable attorney fees.

- *Class Action*

  In the case of a class action suit against a defendant that is subject to Section 10 of the Act, (i.e., regulated by the federal banking agencies, NCUA or the Farm Credit Administration):

  — Such statutory damages as the court may allow up to the lesser of $500,000 or 1 percent of the liable party's net worth;

  — Costs of the action; and

  — Reasonable attorney fees.

In the case of a class action suit against a defendant that is not subject to Section 10 of the Act, (i.e., not regulated by the federal banking agencies, NCUA, or the Farm Credit Administration):

  — Actual damages (including interest accruing on such damages);

  — Statutory damages up to $1,000 per class member but not to exceed the lesser of (i) $500,000; or (ii) 1 percent of the liable party's gross revenues;

  — Costs of the action; and

  — Reasonable attorney fees (12 USC 4907(a)).

B. Statute of Limitations

A borrower must bring an action under the Act within two years after the borrower discovers the violation (12 USC 4907(b)).

C. Mortgage Servicer Liability Limitation

A servicer shall not be liable for its failure to comply with the requirements of the Act if the servicer's failure to comply is due to the mortgage insurer's or lender's failure to comply with the Act (12 USC 4907(c)).

X. Enforcement

The Act directs the federal banking agencies to enforce the Act under 12 USC 1818 or any other authority conferred upon the agencies by law. Under the Act the agencies shall:

- Notify applicable lenders or servicers of any failure to comply with the Act;
- Require the lender or servicer, as applicable, to correct the borrower's account to reflect the date on which PMI should have been canceled or terminated under the Act; and
- Require the lender or servicer, as applicable, to return unearned PMI premiums to a borrower who paid premiums after the date on which the borrower's obligation to pay PMI premiums ceased under the Act (12 USC 4909).

Homeowners Protection Act Examination Objectives

1. To determine the financial institution's compliance with the Homeowners Protection Act of 1998 (HPA), as amended.
2. To assess the quality of the financial institution's policies and procedures for implementing the HPA.
3. To determine the reliance that can be placed on the financial institution's internal controls and procedures for monitoring the institution's compliance with the HPA.
4. To initiate corrective action when violations of HPA are identified, or when policies or internal controls are deficient.

Examination Procedures

1. Through discussions with management and review of available information, determine if the institution's internal controls are adequate to ensure compliance with the HPA. Consider the following:

   a. Organization charts

   b. Process flowcharts

   c. Policies and procedures

   d. Loan documentation

   e. Checklists

   f. Training

   g. Computer program documentation

2. Review any compliance audit material, including work papers and reports, to determine whether:

   a. The institution's procedures address all applicable provisions of HPA;

   b. Steps are taken to follow-up on previously identified deficiencies;

   c. The procedures used include samples covering all product types and decision centers;

   d. The compliance audit work performed is accurate;

   e. Significant deficiencies and their causes are included in reports to management and/or to the Board of Directors;

   f. Corrective action is taken in a timely and appropriate manner; and

   g. The frequency of compliance review is appropriate.

3. Review sample transactions, disclosure and notification forms, and the financial institution's policies and procedures to ensure the institution provides:

   - Initial Disclosures for (i) fixed rate mortgages, (ii) adjustable rate mortgages, (iii) high risk loans, and (iv) lender paid mortgage insurance;
   - Annual Notices for (i) fixed and adjustable rate mortgages and high risk

loans, and (ii) existing residential mortgages; and

- Notices of (i) cancellation, (ii) termination, (iii) grounds for not canceling PMI, (iv) grounds for not terminating PMI, (v) cancellation date for adjustable rate mortgages, and (vi) termination date for lender paid mortgage insurance.

(Refer to Appendix A for required content of the disclosure and notices.)

4. Using the above sample and bank policies and procedures, determine that borrowers are not charged for any required disclosures or notifications (12 USC 4906).

5. Obtain and review a sample of recent written requests from borrowers to cancel their private mortgage insurance (PMI) on “non-high risk” residential mortgage transactions. Verify that the insurance was cancelled on either (a) the date on which the principal balance of the loan was first scheduled to reach 80 percent of the original value of the property based on the initial amortization schedule (in the case of a fixed rate loan) or amortization schedule then in effect (in the case of an adjustable rate loan) or (b) the date on which the principal balance of the loan actually reached 80 percent of the original value of the property based on actual payments, in accordance with the applicable provisions in 12 USC 4902(a)of HPA (*i.e.*, good payment history, current payments and, if required by the lender, evidence that the value of the mortgaged property did not decline, and certification that the borrower’s equity was unencumbered by a subordinate lien) (12 USC 4902(a)).

6. Obtain and review a sample of “non-high risk” PMI residential mortgage transactions where the borrower did not request cancellation. Select loans from the sample that have reached a 78 percent or lower LTV ratio based on the original value of the property and that are not current. Verify that PMI was terminated, based on the initial amortization schedule (in the case of a fixed rate loan) or the amortization schedule then in effect (in the case of an adjustable rate loan) on the date that the principal balance of the loan was first scheduled to reach 78 percent of the original value of the mortgaged property (if the borrower was current) or on the first day of the first month after the date that the borrower became current (12 USC 4902(b)).

7. Obtain a sample of PMI-covered residential mortgage transactions (including high-risk loans, if any) that are at or beyond the midpoint of their amortization period. Determine whether PMI was terminated by the first day of the following month if the loan was current. If the loan was not current at the midpoint, determine that PMI was terminated by the first day of the month following the day the loan became current. If, at the time of the examination, a loan at the midpoint is not current, determine whether the financial institution is monitoring the loan and has systems in place to ensure that PMI is terminated when the borrower becomes current (12 USC 4902(c) and 12 USC 4902(g)(2)).

8. Obtain a sample of any lender defined “high risk” PMI residential mortgage transactions that have a 77 percent or lower LTV based on the original value of the property. Verify that PMI was cancelled, based on the initial amortization schedule (in the case of a fixed rate loan) or the amortization schedule then in effect (in the case of an adjustable rate loan), on the date that the principal balance of the loan was scheduled to reach 77 percent of the original value of the mortgaged property (12 USC 4902(g)(1)(B)).

9. Obtain a sample of loans that have had PMI cancelled or terminated (the samples obtained above can be used). For PMI loans cancelled upon the borrowers’ requests, determine that the financial institution did not require any PMI payment(s) beyond 30 days of the borrower satisfying the evidence and certification requirements to cancel PMI (12 USC 4902(e)(1). For the PMI loans that received automatic termination or final termination, determine that the financial institution did not require any PMI payment(s) beyond 30 days of

termination (12 USC 4902(e)(2) and 12 USC 4902(e)(3)).

10. Using the samples in steps 5, 6, and 7, determine if the financial institution returned unearned premiums, if any, to the borrower within 45 days after cancellation or termination (12 USC 4902(f)(1)).

Conclusions

11. Summarize all violations and internal deficiencies.

12. If the violation(s) and internal deficiencies noted above represent(s) a pattern or practice, determine the root cause by identifying weaknesses in internal controls, compliance review, training, management oversight, or other factors.

13. Identify action needed to correct violations and weaknesses in the institution's compliance system, as appropriate.

14. Discuss findings with the institution's management and obtain a commitment for corrective action.

15. Determine if enforcement action is appropriate. If so, contact appropriate agency personnel for guidance. Section 10(c) of the Act contains a provision requiring restitution of unearned PMI premiums.

This appendix provides guidance about the timing and required content of disclosures and notice to be made in connection with the Act.

1. Initial disclosures at consummation for **fixed rate** residential mortgage transactions must include:

    a. A written amortization schedule (§4(a)(1)(A)(i)).

    b. A notice that the borrower may submit a written request to cancel PMI as of the date that, based on the initial amortization schedule, the principal balance is first scheduled to reach 80% of the original value of the mortgaged property, irrespective of the outstanding balance of the mortgage, or such earlier date that, based on actual payments, the principal balance actually reaches 80% of the original value of the mortgaged property and the borrower has a good payment history and has satisfied the lender's requirements that the value of the mortgaged property has not declined and is unencumbered by subordinate liens (§4(a)(1)(A)(ii)(I) and (II)).

    c. The specific date, based on the initial amortization schedule, the loan balance is scheduled to reach 80% of the original value of the mortgaged property (§4(a)(1)(A)(ii)(I)).

    d. A notice that PMI will automatically terminate on the date that, based on the amortization schedule and irrespective of the outstanding balance of the mortgage, the principal balance is first scheduled to reach 78% of the original value of the mortgaged property if the loan is current (§4(a)(1)(A)(ii)(III)).

    e. The specific date the loan balance is scheduled to reach 78% LTV (§4(a)(1)(A)(ii)(III)).

    f. Notice that exemptions to the right to cancel and automatic termination exist for high-risk loans and whether such exemptions apply (§4(a)(1)(A)(ii)(IV)).

2. Initial disclosures at consummation for **adjustable rate** residential mortgage transactions must include a notice that:

    a. The borrower may submit a written request to cancel PMI as of the date that, based on the amortization schedule(s) and irrespective of the outstanding balance of the mortgage, the principal balance is first scheduled to reach 80% of the original value of the mortgaged property or such earlier date that, based on actual payments, the principal balance actually reaches 80% of the original value of the mortgaged property and the borrower has a good payment history and has satisfied the lender requirements that the value of the mortgaged property has not declined and is unencumbered by subordinate liens (§4(a)(1)(B)(i)).

    b. The servicer will notify the borrower when the cancellation date is reached, *i.e.,* when the loan balance represents 80% of the original value of the mortgaged property (§4(a)(1)(B)(I)).

    c. PMI will automatically terminate when the loan balance is first scheduled to reach 78% of the original value of the mortgaged property irrespective of the outstanding balance of the mortgage and the loan is current (§4(a)(1)(B)(ii)).

    d. On the termination date the borrower will be notified of the termination or the fact that PMI will be terminated when the loan is brought current (§4(a)(1)(B)(ii)).

    e. Exemptions to the right to cancel and automatic termination exist for high-risk loans and whether such exemptions apply (§ 4(a)(1)(B)(iii)).

3. Lender has established standards regarding the type of evidence it requires borrowers to provide to demonstrate that the value of the mortgage property has not declined and they are provided when a request for cancellation occurs (§ 3(a)(3)(A)).

4. Lender provides written initial disclosures at consummation for high risk residential mortgage transactions (as defined by the lender or Fannie Mae or Freddie Mac), that PMI will not be required beyond the midpoint of the amortization period of the loan, if the loan is current (4(a)(2)).

5. When the financial institution acts as servicer for residential mortgage transactions, it provides an annual written statement to the borrowers explaining their rights to cancel or terminate PMI and an address and telephone number to contact the servicer to determine whether they may cancel PMI (§4(a)(3)). (Note: This disclosure may be included on RESPA's annual escrow account disclosure or IRS interest payment disclosures.)

6. When the financial institution acts as servicer, it provides an annual written statement to each borrower who entered into a residential mortgage prior to July 29, 1999, that includes:

   a. A statement that PMI may, under certain circumstances, be canceled by the borrower with the consent of the lender or in accordance with applicable state law (§4(b)(1)).

   b. An address and telephone number that the borrower may use to contact the servicer to determine whether the borrower may cancel the PMI (§ 4(b)(2)). (Note: This disclosure may be included on RESPA's annual escrow account disclosure or IRS interest payment disclosure.)

7. When the financial institution acts as servicer for residential mortgage transactions, it provides borrowers written notices within 30 days after the date of cancellation or termination of PMI that the borrower no longer has PMI and that no further PMI payments or related fees are due (§ 5(a)).

8. When the financial institution services residential mortgage transactions, it returns all unearned PMI premiums to the borrower within 45 days of either termination upon the borrower's request or automatic termination under the HPA (§3(e)).

9. When the financial institution acts as servicer for residential mortgage transactions, it provides borrowers written notices of the grounds it relied on (including the results of any appraisal) to deny a borrower's request for PMI cancellation, no later than 30 days after the date the request is received, or the date on which the borrower satisfies any evidence and certification requirements established by the lender, whichever is later (§5(b)(1) and §5(b)(2)(A)).

10. When the financial institution acts as servicer for residential mortgage transactions, it provides borrowers written notices of the grounds it relied on (including the results of any appraisal) for refusing to automatically terminate PMI not later than 30 days after the scheduled termination date (§5(b)(2)(B)).

Note: The scheduled termination date is reached when, based on the initial amortization schedule (in the case of a fixed rate loan) or the amortization schedule(s) (in the case of an adjustable rate loan), the principal balance of the loan is first scheduled to reach 78% of the original value of mortgaged property, assuming the borrower is current on that date or the earliest date thereafter on which the borrower becomes current.

11. When the financial institution acts as a servicer for adjustable rate residential mortgage transactions, the financial institution notifies borrowers that the cancellation date has been reached (§4(a)(1)(B)(i)).

12. When the financial institution acts as a servicer for adjustable rate residential mortgage transactions, the financial institution notifies the borrowers on the termination date that PMI has been cancelled or will be cancelled as soon as the borrower is current on loan payments (§4(a)(1)(B)(ii)).

13. When the financial institution requires "Lender Paid Mortgage Insurance" (LPMI) for residential mortgage transactions, it provides a written notice to a prospective borrower on or before the loan commitment date that includes:

a. A statement that LPMI differs from borrower paid mortgage insurance (BPMI) in that the borrower may not cancel LPMI, while BPMI is subject to cancellation and automatic termination under the HPA (§6(c)(1)(A)).

b. A statement that LPMI usually results in a mortgage with a higher interest rate than BPMI (§6(c)(1)(B)(i)).

c. A statement that LPMI only terminates when the transaction is refinanced, paid off, or otherwise terminated (§6(c)(1)(B)(ii)).

d. A statement that LPMI and BPMI both have benefits and disadvantages and a generic analysis reflecting the differing costs and benefits of each over a 10-year period, assuming prevailing interest and property appreciation rates (§6(c)(1)(C)).

e. A statement that LPMI may be tax-deductible for federal income taxes if the borrower itemizes expenses for that purpose (§6(c)(1)(D)).

14. If the lender requires LPMI for residential mortgage transactions, and the financial institution acts as servicer, does it notify the borrower in writing within 30 days of the termination date that would have applied if it were a BPMI transaction, that the borrower may wish to review financing options that could eliminate the requirement for PMI (§6(c)(2)).

15. When the financial institution prohibits borrower paid fees for the disclosures and notifications required under the HPA (§7).

CHAPTER: Consumer Affairs Laws and Regulations

SECTION: Consumer Leasing — Section 325

Introduction

Overview

For consumers, leasing is an alternative to buying either with cash or on credit. A lease is a contract between a lessor (the property owner) and a lessee (the property user) for the use of property subject to stated terms and limitations for a specified period and at a specified payment.

The Consumer Leasing Act (15 USC 1667 et. seq.) (CLA) was passed in 1976 to assure that meaningful and accurate disclosure of lease terms is provided to consumers before entering into a contract. It applies to consumer leases of personal property. With this information, consumers can more easily compare one lease with another, as well as compare the cost of leasing with the cost of buying on credit or the opportunity cost of paying cash. In addition, the CLA puts limits on balloon payments sometimes due at the end of a lease, and regulates advertising.

Originally, the CLA was part of the Truth in Lending Act, and was implemented by Regulation Z. When Regulation Z was revised in 1981, Regulation M was issued, and contained those provisions that govern consumer leases.

Today a relatively small number of banks engage in consumer leasing. The trend seems to be for leasing to be carried out through specialized bank subsidiaries, vehicle finance companies, other finance companies, or directly by retailers.

Key Definitions

The definition of certain terms is necessary to understand the requirements imposed by the CLA. These terms include lease, lessor, lessee, consumer lease, open-end lease, closed-end lease, realized value, residual value, gross capitalized cost, capitalized cost reduction, and adjusted capitalized cost.

Approved – FFIEC

Lessee

A lessee is a natural person who enters in to or is offered a consumer lease.

Lessor

A lessor is a natural person or organization who regularly leases, offers to lease, or arranges for the lease of personal property under a consumer lease. A person who leases or offers to lease more than five times in the preceding or current calendar year meets this definition.

Consumer Lease

A consumer lease is a contract between a lessor and a lessee:

- for the use of personal property by an individual (natural person),
- to be used primarily for personal, family, or household purposes,
- for a period of more than 4 months (week-to-week and month-to-month leases do not meet this criterion, even though they may be extended beyond 4 months), and
- with a total contractual cost of no more than $25,000.

Specifically *excluded* from coverage are leases that are:

- for business, agricultural or made to an organization or government,
- for real property,
- for personal property which are incidental to the lease of real property, subject to certain conditions, and
- for credit sales, as defined in Regulation Z §226.2(a)(16).

A lease meeting all of these criteria is covered by the CLA and the Federal Reserve Board's Regulation M. If any one of these criteria is not met, for example, if the leased property is used primarily for business purposes or if the total contractual cost exceeds $25,000, the CLA and Regulation M do not apply.

Consumer leases fall into one of two categories: closed end and open end. Since the information required to be disclosed to the consumer will vary with the kind of lease, it is important to note the difference between them. However, to properly understand the difference, realized value and residual value must first be defined.

Realized Value

The realized value is the price received by the lessor of the leased property at disposition, the highest offer for disposition of the leased property, or the fair market value of the leased property at the end of the lease term.

Residual Value

The residual value is the value of the leased property at the end of the lease, as estimated or assigned at consummation of the lease by the lessor.

Open-end Lease

An open-end lease is a lease in which the amount owed at the end of the lease term is based on the difference between the residual value of the leased property and its realized value. The consumer may pay all or part of the difference if the realized value is less than the residual value or he may get a refund if the realized value is greater than the residual value at scheduled termination.

Closed-end Lease

A closed-end lease is a lease other than an open-end lease. This type of lease allows the consumer to "walk away" at the end of the contract period, with no further payment obligation – unless the property has been damaged or has sustained abnormal wear and tear.

Gross Capitalized Cost

The gross capitalized cost is the amount agreed upon by the lessor and lessee as the value of the leased property, plus any items that are capitalized or amortized during the lease term. These items may include taxes, insurance, service agreements, and any outstanding prior credit or lease balance.

Capitalized Cost Reduction

This term means the total amount of any rebate, cash payment, net trade-in allowance, and noncash credit that reduces the gross capitalized cost.

Adjusted Capitalized Cost

This is the gross capitalized cost less the capitalized cost reduction and the amount used by the lessor in calculating the base periodic payment.

General Disclosure Requirements

Lessors are required by federal law to provide the consumer with leasing cost information and other disclosures in a format similar to the model disclosure forms found in Appendix A to the regulation. Certain pieces of this information must be kept together and must be segregated from other lease information. All of the information stated must be accurate, clear and conspicuous, and provided in writing in a form that the consumer may keep.[1] Disclosures are to be provided in the following circumstances.

Prior to or Due at Lease Signing

A dated disclosure must be given to the consumer before signing the lease and must contain all of the information detailed in Section 4 of the regulation.

Renegotiations and Extensions

New disclosures also must be provided when a consumer renegotiates, or extends a lease, subject to certain exceptions.

[1] Alternatively, the information may be provided electronically, where agreed to by the consumer. The provisions to provide disclosures electronically are currently not mandatory. (7/2002)

Multiple Lessors/Lessees

In the event of multiple lessors, one lessor on behalf of all the lessors may make the required disclosures. If the lease involves more than one lessee, the required disclosures should be given to any lessee who is primarily liable.

Advertising

Advertisements concerning consumer leases must also comply with certain disclosure requirements. All advertisements must be accurate. If a printed ad includes any reference to certain “trigger terms” – the amount of any payment, statement of a capitalized cost reduction (i.e., down payment), or other payment required prior to or at lease signing or delivery, or that no such payment is required – then the ad must also state the following:

- that the transaction is for a lease,
- the total amount due prior to or at lease signing or delivery,
- the number, amounts and due dates or periods of the scheduled payments, and
- a statement of whether or not a security deposit is required.

An advertisement for an open-end lease also must include a statement that extra charges may be imposed at the end of the lease based on the difference between the residual value and the realized value at the end of the lease term.

If lessors give a percentage rate in an advertisement, the rate cannot be more prominent than any of the other required disclosures. They must also include a statement that “this percentage may not measure the overall cost of financing this lease.” The lessor cannot use the term “annual percentage rate,” “annual lease rate,” or any equivalent term.

Some fees (license, registration, taxes, and inspection fees) may vary by state or locality. An advertisement may exclude these third-party fees from the disclosure of a periodic payment or total amount due at lease signing or delivery, provided the ad states that these have been excluded. Otherwise, an ad may include these fees in the periodic payment or total amount due, provided it states that the fees are based on a particular state or locality and indicates that the fees may vary.

Limits on Balloon Payments

In order to limit balloon payments that may be required of the consumer, certain sections of the regulation call for reasonable calculations and estimates. These provisions protect the consumer at early termination of a lease, at the end of the lease term, or in delinquency, default, or late payment status. The provisions limit the lessee’s liability at the end of the lease term and set reasonableness standards for wear and use charges, early termination charges, and penalties or fees for delinquency.

Penalties and Liability

Criminal and civil liability provisions of the Truth in Lending Act also apply to the CLA. Actions alleging failure to disclose the required information, or otherwise comply with the CLA, must be brought within one year of the termination of the lease agreement.

Record Retention

Lessors are required to maintain evidence of compliance with the requirements imposed by Regulation M, other than the advertising requirements under Section 7 of the regulation, for a period of not less than two years after the date of the disclosures are required to be made or an action is required to be taken.

Examination Objectives

1. To assess the quality of the institution’s compliance management system for the Consumer Leasing Act.
2. To determine that lessees of personal property are given meaningful and accurate disclosures of lease terms.
3. To determine if the limits of liability are clearly indicated to the lessees and correctly enforced by the institution.

4. To ensure that the financial institution provides accurate disclosures of its leasing terms in all advertising.

Examination Procedures

General Disclosure Requirements

A. Review the institution's procedures for providing disclosures to ensure that there are adequate controls and procedures to effect compliance.

B. Review the disclosures provided by the institution.

   1. Are the disclosures clear and conspicuous and provided in writing in a form the consumer may keep? Alternatively, are they provided electronically where agreed to by the consumer? (§213.3(a) & §213.3(a)(5))[2]

   2. Are the disclosures given in a dated statement and in the prescribed format? (§213.3(a)(1))

   3. Is the information required by sections 213.4(b) through (f), (g)(2), (h)(3), (i)(1), (j), and (m)(1) segregated and in a form substantially similar to the model in Appendix A? (§213.3(a)(2))

   4. Are the disclosures timely? (§213.3(a)(3))

   5. If the lease involves more than one lessee, are the disclosures provided to any lessee who is primarily liable? (§213.3(c))

   6. If additional information is provided, is it provided in a manner such that it does not mislead or confuse the lessee? (§213.3(b))

   7. Are all estimates clearly identified and reasonable? (§213.3(d))

   8. Are the disclosures accurate and do the disclosures contain the information required by section 213.4 (a) through (t)? (§213.4)

   9. Are disclosures given to lessees when they "renegotiate" or "extend" their leases? (§213.5)

Lessee Liability

A. Review the lease estimates and calculations to ensure that there is not any unreasonable balloon payment expected of the lessee in the following circumstances:

   - at early termination,

     1. Does the lessor disclose the conditions under which the lease may be terminated early and the amount and method of determining the amount of any early termination charges? (§213.4(g)(1)

     2. Are any early termination charges reasonable? (§213.4(g)(1), (q))

   - at end of lease term, for wear and use,

     1. If the lessor sets standards for wear and use of the leased vehicle are the amounts or method of determining any charge for excess mileage disclosed? (§213.4(h)(3))

     2. Are standards for wear and use reasonable? (§213.4(h)(2))

   - at end of lease term (for open-end leases), and

     1. Does the lessor disclose the limitations on the lessee's liabilities at the end of the lease term? (§213.4(m)(2))

[2] The provisions to provide disclosures electronically are currently not mandatory. (7/2002)

2. Are the lessee and lessor permitted to make a mutually agreeable final adjustment regarding excess liability? (§213.4(m)(3))

- in delinquency, default or late payment.

1. Does the lessor disclose penalties or other charges for delinquency, default or late payments? (§213.4(q))

2. Are the penalties or other charges reasonable? (§213.4(q))

Advertising

A. Review advertising policies and procedures used by the institution to ensure that there are adequate controls and procedures to effect compliance.

B. Review a sample of the institution's advertisements.

1. Do the advertisements advertise terms that are usually and customarily available? (§213.7(a))

2. Are the disclosures contained in the advertisements clear and conspicuous? (§213.7(b))

3. Do catalog/multiple page advertisements comply with the page reference requirements? (§213.7(c))

4. When triggering terms are used, do the advertisements contain the additional required information? (§213.7(d))

5. Do merchandise tags which use triggering terms refer to a sign or display that contains the additional required disclosures? (§213.7(e))

6. If television or radio advertisements use triggering terms, if they do not contain the additional terms required by §7(d)(2), do they use alternative disclosure methods (direct consumers to a toll free number or written advertisement)? (§213.7(f))

Miscellaneous

1. Are records and other evidence of compliance retained for a period of no less than two years? (§213.8)

References

Laws

15 USC 1667	Consumer Leasing Act of 1976 Et. Seq.

Regulations

12 CFR 213	Federal Reserve System Regulation M

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Instructions for Completing Form:

This checklist is an aid to analysis of the institution's compliance program for consumer leasing operations. It is not a mandatory workpaper. It should be applied to the extent warranted by your risk-based scoping judgment. The columns correspond to the OTS Self-Assessment Guide summary of comprehensive compliance program components: Systems, Monitoring, Assessment, Accountability, Response, Training.

S	M	A	A	R	T	
						1. Does the Bank engage in consumer leasing or purchase consumer leases from lessors? (§213.2(h))
						(If no, there is no need to do further work on Consumer Leasing. If yes, complete the following checklist, answering yes (Y) or no (N) for each item.)
						2. Are the disclosures made prior to consummation of the lease, that is, at the time a binding order is made or the lease is signed? (§213.3(a)(3))
						3. Are the disclosures clear and conspicuous and provided in writing in a form the consumer may keep? (§213.3(a))
						4. Are the disclosures given in a dated statement and (i) made either in a separate statement that identifies the consumer lease transaction, (ii) in the contract or (iii) other document evidencing the lease? (§213.3(a)(1))
						5. Is the information required by sections 213.4(b) through (f), (g)(2), (h)(3), (i)(1), (j), and (m)(1) segregated and in a form substantially similar to the model in Appendix A? (§213.3(a)(2))
						6. If the lease involves more than one lessee, are the disclosures provided to any lessee who is primarily liable? (§213.3 (c))
						7. Alternatively, are they provided electronically where agreed to by the consumer? (§213.3(a)(5))[3]
						8. If additional information is provided, is it provided in a manner such that it does not mislead or confuse the lessee? (§213.3(b))
						9. Are disclosures provided to at least one lessee where there are multiple lessees and by at least one lessor when there are multiple lessors? (§213.3(c))
						10. Are all estimates clearly identified and reasonable? (§213.3(d))
						11. Are the following disclosures made in the lease?
						A. Description of property (§213.4(a))
						B. Amount due at lease signing or delivery (§213.4(b))
						C. Payment schedule and total amount of periodic payments (§213.4(c))

[3] The provisions to provide disclosures electronically are currently not mandatory. (7/2002)

S	M	A	A	R	T	
						D. Other charges (§213.4(d))
						E. Total of payments (§213.4(e))
						F. Regarding payment calculations:
						i. Gross capitalized cost (§213.4(f)(1))
						ii. Capitalized cost reduction (§213.4(f)(2))
						iii. Adjusted capitalized cost (§213.4(f)(3))
						iv. Residual value (§213.4(f)(4))
						v. Depreciation and any amortized amounts (§213.4(f)(5))
						vi. Rent charge (§213.4(f)(6))
						vii. Total of base periodic payments (§213.4(f)(7))
						viii. Lease payments (§213.4(f)(8))
						ix. Basic periodic payment (§213.4(f)(9))
						x. Itemization of other charges (§213.4(f) (10))
						xi. Total periodic payment (§213.4(f) (11))
						G. Regarding early termination:
						i. Conditions under which the lessee or lessor may terminate the lease prior to the end of the lease term (§213.4(g)(1))
						ii. The amount or description of the method for determining the amount of any penalty or other charges for early termination (§213.4(g)(1))
						iii. In a form substantially similar to the sample (§213.4(g)(2))
						H. Regarding notice of wear and use
						i. A statement specifying whether the lessor or the lessee is responsible for maintaining or servicing the leased property, with a description of the responsibility (§213.4(h)(1))
						ii. A statement of the lessor's standards for wear and use, which must be reasonable (§213.4(h)(2))
						iii. In a form substantially similar to the sample (§213.4(h)(3))
						I. Purchase option (§213.4(i))
						J. Statement referencing other nonsegregated disclosures (§213.4(j))
						K. Liability between residual and realized values (§213.4(k))

S	M	A	A	R	T	
						L. Right of appraisal (§213.4(l))
						M. For open-end leases,
						i. the rent and other charges paid by lessee (§213.4(m)(1))
						ii. liability at end of lease term based on residual value and any excess liability (§213.4 (m) and (m)(2))
						iii. mutually agreeable final adjustment (§213.4(m)(3))
						N. Fees and taxes (§213.4(n))
						O. Regarding insurance,
						i. Are the types and amounts of insurance that the lessee is required to have disclosed? (§213.4(o))
						ii. If the lessor provides insurance, are the types, amounts, and cost also disclosed? (§213.4(o)(1))
						P. Warranties or guarantees (§213.4 (p))
						Q. Penalties and other charges for late payments, delinquency, or default (§213.4(q))
						R. Security interest other than a security deposit (§213.4(r))
						S. Regarding any information on rate:
						i. Does the lessor use the term “annual percentage rate,” “annual lease rate,” or any equivalent term in the lease disclosure? (§213.4(s))
						ii. If so, does a statement that “this percentage may not measure the overall cost of financing this lease” accompany the rate? (§213.4(s))
						12. Are disclosures given to lessees when they “renegotiate” or “extend” their leases? (§213.5)
						13. Does the bank advertise its leasing program? If so,
						A. Do the advertisements advertise terms that are usually and customarily available? (§213.7(a))
						B. Are the advertisements clear and conspicuous? (§213.7(b))
						i. Are any affirmative or negative references to a charge that is part of the disclosure required under paragraph (d)(2)(ii) less prominent than the disclosure (except for the statement of a periodic payment? (§213.7(b)(1))

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						ii. Are the advertisements of lease rates less prominent than any disclosure required by section 4 (except the notice of the limitations on rate)? (§213.7(b)(2))
						C. Do catalog and multiple page advertisements comply with the page reference requirements? (§213.7(c))
						D. If any triggering terms are used, are all the following disclosures made (§213.7(d)(2))
						i. That the transaction advertised is a lease
						ii. The total amount due prior to or at consummation or by delivery, if delivery occurs after consummation
						iii. The number, amounts, and due dates or periods of scheduled payments under the lease
						iv. A statement of whether or not a security deposit is required
						v. A statement that an extra charge may be imposed at the end of the lease term where the lessee's liability (if any) is based on the difference between the residual value of the leased property and its realized value at the end of the lease term.
						14. Do merchandise tags which use triggering terms refer to a sign or display that contains the additional required disclosures. (§213.7(e))
						15. Do television or radio advertisements that do not contain the additional information required by section 4(d)(2) direct consumers to a toll-free number or written advertisement for additional information when triggering terms are used? (§213.7)
						A. Is the toll free number listed along with a reference that the number may be used by consumer to obtain the information? (§213.7(f)(1)(i))
						B. Does the written advertisement that is in general circulation in the community served by the station including the name and date of the publication, and is published beginning at least three days before and ending at least ten days after broadcast? (§213.7(f)(1)(ii))
						C. Has the toll-free telephone number been available for no fewer than ten days, beginning on the date of broadcast? (§213.7(f)(2)(i))
						D. Does the lessor provide the information required by paragraph (d)(2) over the toll-free number, orally or in writing upon request? (§213.7(f)(2)(ii))
						16. Are records and other evidence of compliance retained for a period of no less than two (2) years as required by the CLA? (§213.8)

Introduction

Section 106 (c)(5) of the Housing and Urban Development Act of 1968 (the Act) (12 USC 1701x(c)(5)) provides for homeownership counseling notification by creditors to eligible homeowners. The Act has been amended at various times,[1] with the most recent amendment on November 26, 2001, when the Departments of Veterans Affairs and Housing and Urban Development, and Independent Agencies Appropriations Act of 2002 (Pub. L. 107-73) was enacted. Section 205 of that Act repealed the previous sunset provision.

Applicability

All creditors that service loans secured by a mortgage or lien on a one-family residence (home loans) are subject to the homeownership counseling notification requirements. Home loans include conventional mortgage loans and loans insured by the Department of Housing and Urban Development (HUD).

Approved – FFIEC

Requirements

Notice Requirements[2]

A creditor or proposed creditor must provide notification of the availability of homeownership counseling to a homeowner, eligible for counseling, who fails to pay any amount by the due date under the terms of the home loan.

Eligibility

A homeowner must be given homeownership counseling notification if:

- The home loan is secured by the homeowner's principal residence;
- The home loan is not assisted by the Farmers Home Administration; and
- The homeowner is, or is expected to be, unable to make payments, correct a home loan delinquency within a reasonable time, or resume full home loan payments due to a reduction in the homeowner's income because of:
  - — An involuntary loss of, or reduction in, the homeowner's employment, the homeowner's self-employment, or income from the pursuit of the homeowner's occupation; or
  - — Any similar loss or reduction experienced by any person who contributes to the homeowner's income.

[1] Section 577 of the National Affordable Housing Act of 1990 (Pub. L. 101-625) extended the homeownership counseling provisions to September 30, 1992; Section 162 of the Housing and Community Development Act of 1992 (Pub. L. 102-550) extended the provisions to September 30, 1994; and Section 594 of the Departments of Veterans Affairs and Housing and Urban Development, and Independent Agencies Appropriation Act of 1999 (Pub. L. 105-276) extended the provisions to September 30, 2000.

[2] The FFIEC Consumer Compliance Task Force has requested clarification from HUD on HUD's current position regarding notice requirements to first-time homebuyers. These interagency examination procedures are currently limited to determining compliance with the Act's notice provisions related to delinquent borrowers. However, should a response from HUD to the Task Force indicate that notices to first-time homebuyers should be provided under the Act, the agencies will expand these examination procedures to cover notices to first-time homebuyers.

Contents of Notice

The notice must:

1. notify the homeowner of the availability of any homeownership counseling offered by the creditor; and
2. provide either a list of HUD-approved non-profit homeownership counseling organizations or the toll-free number[3] HUD has established through which a list of such organizations may be obtained.

Timing of Notice

The notice must be given to a delinquent homeowner borrower no later than 45 days after the date on which the homeowner becomes delinquent. If, within the 45-day period, the borrower brings the loan current again, no notification is required.

Definitions

For purposes of these requirements, the following definitions apply:

"Creditor" means a person or entity that is servicing a home loan on behalf of itself or another person or entity.

"Home loan" means a loan secured by a mortgage or lien on residential property.

"Homeowner" means a person who is obligated under a home loan.

"Residential property" means a 1-family residence, including a 1-family unit in a condominium project, a membership interest and occupancy agreement in a cooperative housing project, and a manufactured home and the lot on which the home is situated.

Examination Objective

To determine whether the financial institution has established procedures regarding homeownership counseling notification requirements to ensure that it is in compliance with the provisions of Section 106(c)(5) of the Housing and Urban Development Act of 1968.

Examination Procedures

Determine if the financial institution is informing eligible homeowners, within 45-days of an initial loan default, of: (1) the availability of any homeownership counseling offered by the creditor; and (2) the availability of any homeownership counseling by nonprofit organizations approved by HUD, or the toll-free telephone number through which the homeowner can obtain a list of such organizations.

Examination Checklist

1. Does the financial institution notify eligible homeowners, within 45-days of initial loan default, of any homeownership counseling the institution (creditor) provides?
2. Does the financial institution provide eligible homeowners with the names of nonprofit organizations approved by HUD or the toll-free telephone number to obtain a list of such organizations?

[3] The number is 1-800-569-4287.