**Board of Governors of the Federal Reserve System**

# Report to the Congress

## *Finance Charges for Consumer Credit under the Truth in Lending Act*

**April 1996**

**FEDERAL RESERVE BOARD STUDY ON FINANCE CHARGES FOR CONSUMER CREDIT UNDER THE TRUTH IN LENDING ACT**

The Truth in Lending Act requires disclosure of the "finance charge," the cost of consumer credit expressed as a dollar amount. The uniform disclosure of financing costs is designed to assist consumers in shopping for credit products. The cost of credit under the act is also expressed as an annual percentage rate. The finance charge does not include every cost associated with obtaining consumer credit, such as many charges paid in a real estate-secured loan. From the beginning of the discussion about the concept of "Truth in Lending" in the 1960s there has been a considerable debate about which costs should be classified as finance charges for disclosure purposes. Over the years, a complex set of rules has attempted to define with precision which charges should or should not be considered finance charges. Despite these rules, ambiguities have persisted, and in recent years lenders have become increasingly concerned about litigation alleging incorrect categorization of these charges.

The Truth in Lending Act Amendments of 1995 represent a reaction to many of the specific issues raised in the court cases. The amendments expressly exclude from the finance charge some of the specific fees that were the subject of litigation. But as a more fundamental approach to the problem, section 2(f) of the 1995 Amendments directs the Board to report to the Congress on how the finance charge could be modified to more accurately reflect the cost of consumer credit. The report is to discuss the feasibility of treating as finance charges all costs required by the creditor or paid by the consumer as an incident of the credit. The Board is also asked to address any abusive refinancing practices that creditors may use to avoid the three-day right of rescission provided by the law for certain transactions secured by the borrower's home.

This report presents the Board's preliminary analysis of these issues. These matters are highly complex and the short statutory deadline for this report did not allow for the Board to draw definitive conclusions about them. Consequently, this preliminary report will be supplemented by a more thorough report at a later date that will take advantage, for example, of further input from the Board's Consumer Advisory Council, consumer surveys, and other additional sources of information.

## A. FINANCE CHARGES

### Finance Charge Rules Under the Truth in Lending Act

The Truth in Lending Act (TILA), 15 U.S.C. §§ 1601 - 1666j, and the Board's Regulation Z, 12 C.F.R. Part 226, contain rules that govern disclosures at all stages of the credit shopping process. The level of detail about the potential costs vary -- from limited disclosures in advertisements to transaction-specific disclosures before consumers become obligated for a debt. The TILA's principal cost disclosure is the "finance charge," defined as the cost of consumer credit expressed as a dollar amount. It includes any charge payable

directly or indirectly by the consumer or imposed directly or indirectly by the creditor as an incident to or a condition of the extension of credit. Examples of a finance charge include interest, points, and service or transaction fees.

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

Still other costs that are generally included in the finance charge may nevertheless be excluded in some circumstances. For example, the TILA provides that credit report fees are finance charges, but makes an exception for credit report fees associated with real estate and most home-secured loans. The act also excludes optional credit life insurance premiums and fees to record a security interest if the costs are disclosed to the consumer and other conditions are met. 15 U.S.C. § 1605; 12 C.F.R. § 226.4.

**Finance Charge Expressed as an Annual Percentage Rate**

The TILA and Regulation Z require creditors to disclose the cost of consumer credit as an annual percentage rate (APR), in addition to disclosing finance charges as a dollar amount. Creditors must disclose an APR for all types of consumer credit -- installment loans (closed-end credit) and credit card accounts or home-equity lines of credit (open-end plans). But the distinct nature of these products calls for differences in how the APR is calculated.

The APR for closed-end credit is based on the amounts borrowed by the consumer in relation to the amount and timing of payments to the creditor. 15 U.S.C. § 1606; 12 C.F.R. § 226.22. It factors in interest and all other finance charges. Costs such as recording fees or real estate title insurance fees must be disclosed, but are not treated as a part of the finance charge and thus are excluded from the APR calculation. The APR for closed-end credit must be stated in certain advertisements and must be provided in disclosures before the consumer becomes obligated on the transaction. The APR stated in advertisements is a sample, because APRs vary depending on the costs associated with a particular transaction. In closed-end credit, the APR disclosed before the consumer becomes obligated on a given loan reflects the specific "costs of credit" for the entire loan term; no further APR calculations are required during the term of the loan.

Under open-end credit plans, such as credit card accounts and home-equity lines of credit, the creditor typically sets the maximum amount that can be borrowed at any time. The amount that will actually be drawn down by the consumer, however, is seldom known when the credit plan is established. Consequently, the APR stated in advertisements and

account-opening disclosures is not tied to a specific loan amount and reflects only the interest rate that will be applied to any outstanding balance the consumer may have in the future. 15 U.S.C. § 1606; 12 C.F.R. § 226.14. Additional costs -- whether finance or other charges -- are separately identified.

Consumers with outstanding balances on open-end plans receive an APR on periodic statements. That APR is based on the account balance and certain finance charges imposed during the billing cycle. Reflecting other finance charges, such as points charged in establishing a home-equity credit line and other fees to open or renew plans, would substantially increase (and distort) the APR for the billing cycle in which they were imposed -- particularly if only a small amount of credit were outstanding for that cycle. Consequently, these types of finance charges are disclosed on periodic statements but are not figured in the APR. (See 12 C.F.R. § 226.14(c) for the rules on APR calculations for periodic statements.)

**Truth in Lending Act Amendments of 1995**

On September 30, 1995, the Congress enacted the Truth in Lending Act Amendments of 1995. Pub. L. 104-29, 109 Stat. 271. The amendments address the concerns of mortgage lenders stemming from a 1994 court decision, Rodash v. AIB Mortgage Co.[1] In that case, the U.S. Court of Appeals for the Eleventh Circuit allowed a consumer to rescind a mortgage loan -- and recover all fees and finance charges that had been paid -- based on, among other things, errors in the creditor's TILA finance charge disclosures.[2] Subsequently, a number of class-action lawsuits were filed, involving thousands of mortgage loans, alleging similar violations and seeking the remedy of rescission. In reaction to these lawsuits, the 1995 Amendments clarify the treatment of several fees typically associated with real-estate lending. The Amendments also provide five different tolerances for errors in the finance charge calculation for loans secured by real estate or dwellings to take account of minor mischaracterizations of charges that are improperly omitted from the finance charge. Prior to the Amendments there was one tolerance for errors.

During the course of congressional deliberations about the Amendments, there was a suggestion that a more fundamental reexamination of the treatment of finance charges under Truth in Lending was warranted. Accordingly, the 1995 Amendments direct the Board to submit to the Congress a report recommending statutory and regulatory changes on how the definition of the finance charge could be modified, if at all, to more accurately reflect the

[1] 16 F.3d 1142 (11th Cir. 1994).

[2] The Court found that, in connection with a mortgage refinancing, the creditor failed to include $22 in courier fees and a $200 state tax in the finance charge calculation, resulting in the understatement of both the finance charge and the APR.

cost of consumer credit. The study is to discuss the feasibility of including in the finance charge all charges payable directly or indirectly by the consumer and imposed directly or indirectly by the creditor as an incident to the credit transaction (other than costs imposed in comparable cash transactions); this would include costs associated with real estate- or home-secured credit that are not currently treated as part of the finance charge. In short, the purpose of the inquiry is to reexamine the entire underpinnings of the current finance charge calculation. Lumping all the expenses of borrowing into the finance charge and APR disclosures would be one way of easing compliance. Such an approach would, of course, increase the identified "cost" of credit as reflected in the finance charge and APR disclosures.

**Public Comment Relating to Finance Charges**

To assist in this study, the Board published a notice of the congressional report and sought comment on how the rules for finance charges could be modified to more accurately reflect the cost of consumer credit, and asked about the feasibility of including all costs in the finance charge. 60 Fed. Reg. 66179 ( December 21, 1995). The Board received about 200 comments relating to possible changes to the finance charge; nearly 80 percent of the comments were from financial institutions, mortgage lenders, other creditors, service providers, and their trade associations. Seven comments were received from consumer groups.

There is broad support for disclosing the costs of consumer credit. Most commenters also agree that the current rules are complex and inconsistent. Some costs associated with borrowing are labelled as finance charges and others are not; certain fees -- credit report fees, for example -- may be a finance charge in some instances and not in others. Commenters disagree, however, about the extent to which costs should be lumped together as "finance charges" and expressed as an APR.

A number of commenters believe that the current rules should remain unchanged. They recognize that improvements could be made, but suggest that the costs of making changes outweigh the benefits. Other commenters believe that it would be premature for the Board to recommend changes to the finance charge calculation without further study, given the substantial impact that changes in the TILA finance charge and APR rules may have on creditors' practices and on current consumer understanding of these concepts. These commenters suggest a variety of approaches for further study, ranging from forming a task force of industry and consumer representatives to using focus groups to elicit consumer responses about the form and content of cost disclosures.

In summary, the bulk of the commenters agree that current finance charge rules could be improved to more accurately reflect the cost of credit. However, the suggested approaches for changes and the underlying principles offered for those approaches vary significantly.

Defining the "cost" of credit. In considering how the finance charge might be improved, commenters reflected very different perspectives on the "cost" of credit. One view is that the TILA disclosures should identify "what the consumer pays" in connection with the credit transaction. From this perspective, the TILA should include as finance charges all charges paid by the borrower to the creditor or to third parties, such as government officials and service providers (even if the service is optional, such as credit life insurance). Under this approach, only costs that are paid in a comparable cash transaction would be excluded from the finance charge.

Another view of the cost of credit looks at "what the creditor receives" or requires to provide the credit. Many commenters discussed whether fees paid to third parties should be included in the finance charge; some would include fees for services required (or if not required, if the fee was retained by the creditor). However, many commenters oppose any duty on creditors to disclose fees imposed by third parties. These would include fees for such things as appraisals, courier fees, and title insurance. They believe that creditors should not be exposed to liability for the disclosure of costs that, in practice, are often outside their knowledge or control even though use of third party services is required. Some commenters believe the price of optional services -- whether paid to the creditor or a third party -- should never be included as a "cost" of the credit.

Charges that are included in the APR. Many commenters believe the types of charges included in the APR for installment loans should be narrowed to more accurately reflect the cost of consumer credit. A sizeable number of commenters support an APR that is based only on the interest rate (and, for some, creditor-imposed origination fees), along with an itemized list of other charges. Many creditors report that their customers only want to know the interest rate, the monthly payment, and the dollar amount of other costs associated with the loan. They say disparity between the APR and the interest rate confuses consumers, who react with indifference or suspicion to the APR. Commenters offered a variety of suggestions about the accompanying list of fees: Some suggest breaking out fees representing the cash needed at closing; others would simply list all costs, either itemized or as a total. A few commenters suggested that the interest rate and the total amount of costs be accompanied by a figure that represents the total costs as a percentage of the amount borrowed.

Some commenters favor making no changes to the APR rule. They believe that the cost to creditors of adapting to a new APR and the difficulties for consumers in understanding the new concept exceed the benefits of an improved calculation, although they concede the current APR is not a perfect measure of the cost of credit in all circumstances. For example, APRs for home loans are based on the stated maturity of the note (say, twenty years), yet homes are commonly sold within seven or eight years. Therefore, at least in theory, upfront costs such as points which are allocated over the full life of the loan make the loan appear less costly than it would be if these costs were allocated over the average time that the loan is held by the consumer.

Including all Costs in the Finance Charge. Few commenters favor including all costs in the finance charge. The overwhelming majority believe that the suggestion is not feasible in the long run, although many acknowledge the idea has superficial appeal as a simple alternative to the complexity of the current rules.

Those who favor an all-inclusive finance charge rule say it would reduce confusion about whether a particular fee is "in" or "out" of the finance charge calculation. Including all costs in the finance charge -- without exceptions -- is also consistent with the view that the TILA disclosures should identify "what the borrower pays," not "what the creditor receives." Fees paid to third parties would provide a special challenge, given the likelihood that when preparing the disclosure statement creditors will not know with certainty or precision all charges the consumer may ultimately pay. But these commenters believe that the problem is not insurmountable, since the TILA and Regulation Z allow for estimates if an exact fee is unknown at the time disclosures are given.

Some commenters believe an all-inclusive rule would enhance discipline in the marketplace: Creditors would be motivated to police third-party service providers like settlement agents against adding "junk fees." Other creditors object to the potential liability associated with the duty to disclose, accurately and timely, fees over which they have no control (especially where the consumer selects the service provider). They believe also that competition may be reduced if creditors restrict the number of acceptable service providers to ensure accurate disclosures.

Many commenters find it inappropriate to include charges for services the consumer elects to purchase -- optional credit life insurance, for instance -- whether paid to a third party or to the creditor. Other commenters are concerned about the impact of an all-inclusive TILA finance charge rule on other laws. For example, creditors observed that state usury laws might be exceeded if the current pricing on loans were expressed in higher finance charges and APRs. Creditors are also concerned that an all-inclusive finance charge would inadvertently trigger the provisions of the Home Ownership and Equity Protection Act of 1994 (HOEPA). The HOEPA imposes disclosure requirements and substantive limitations on certain closed-end mortgage loans bearing rates or fees above a certain percentage or amount. Commenters believe the law was enacted to target only certain home-equity lending practices, not the vast majority of home-secured loans.

Many commenters discussed the relationship of the TILA cost disclosures and the Real Estate Settlement Procedures Act (RESPA). For most real estate-secured loans, the RESPA requires creditors to provide cost estimates soon after consumers apply and a detailed itemization of costs at the loan closing. Definitions and disclosure requirements for the two laws are similar, but not the same. For example, the RESPA currently requires the disclosure of certain fees paid by a lender to a mortgage broker; the TILA requires that only fees paid by the consumer be disclosed. Commenters particularly asked the Board to

recommend to the Congress that any legislative changes to the TILA should contemplate coordination of the TILA and the RESPA disclosure requirements.

The effect of an all-inclusive finance charge definition on the APR troubles many commenters concerned about consumer understanding. Creditors repeatedly state that their customers do not understand the distinction between the APR and the interest rate, and that the even higher APR resulting from an increased finance charge would create a still greater disparity between those two percentage figures. Some believe that disclosing a higher APR in relation to the interest rate would exacerbate rather than eliminate confusion. Some real estate lenders are concerned about consumers' resistance to a higher APR figure on typical mortgage loans. For example, some commenters suggest that consumers seeking to borrow against the equity in their homes might inappropriately choose an open-end home-secured credit line that has the same costs but shows a lower APR than a closed-end home loan, given the exclusions applicable in the APR calculation for open-end credit products.

Finally, some commenters that oppose an all-inclusive finance charge rule are unconvinced that the new rule would simplify either creditor compliance or consumer understanding. They note the fundamental differences between open-end and closed-end transactions; many suggest that consistency could be better achieved if the APR calculation for installment loans mirrored that for revolving credit. More broadly, commenters observed that even with a more inclusive finance charge definition, disagreement could arise about whether a fee is imposed in a comparable cash transaction, or is part of the cost of the credit.

**Consumer Advisory Council Views**

The Board's Consumer Advisory Council considered possible modifications to the TILA's finance charge at two consecutive meetings -- in November 1995 and in March 1996. The Council is composed of thirty individuals representing creditors, consumer groups, and other constituencies affected by the Board's consumer responsibilities. The Council's Consumer Credit Committee, which like the Council includes representatives both of the financial services industry and of consumer interests, presented the issue to the full Council for deliberation.

Council members had divergent views, echoing the spectrum of opinions expressed by the public in written comments. They agreed that the topic is complex, and that further deliberation is advisable. There was consensus for greater consistency in the categorization of some fees that current law treats as finance charges in some cases and not others. Some members favor taking the additional step to include all costs in the finance charge and APR; others oppose that approach and offered their views on alternatives for the Board's consideration.

Many Council members believe the narrow question of improving the calculation of the finance charge and the APR raises the broader issue of whether the TILA's disclosure scheme works well as a shopping tool for consumer credit in today's marketplace. Several members believe it does not. The credit marketplace has changed since the TILA's enactment in the late 1960s. Increasingly creditors offer their products nationwide and consumers shop for credit via mail, telephone, or electronic mail, or through a broker or realtor for home-purchase loans. Some Council members believe the timing and content of the TILA's disclosure rules should be revised so that better cost information is provided earlier in the shopping process -- before the consumer decides which creditor to use. Particularly for home-secured loans, many Council members believe the detailed TILA disclosures received at loan closing are often overlooked in the flurry of activity that occurs at closings. For these reasons, and others, many Council members support a reexamination of the TILA.

**Board Analysis of Existing Finance Charge Rules and Possible Modifications**

The marketplace offers consumers a broad array of installment and revolving credit products. Creditors frequently offer pricing alternatives within a loan type (charging a higher origination fee in exchange for a lower interest rate, for example). Many creditors also offer ancillary products or services that are not required to obtain the credit, but that the consumer may choose to purchase, such as credit life insurance.

This myriad of choices presents a distinct challenge to the TILA's framework for "meaningful" cost disclosures. To be meaningful, disclosures must be accurate and complete. They should be detailed enough to enable the borrower to understand the effect of different pricing alternatives, but generic enough to permit an easy comparison of the overall cost between products and creditors.

Accurate, complete disclosures can result from simple rules applied to simple loans or credit sales. The ability to assure accurate disclosure of the "true" costs gets more difficult as creditors increase the number of credit products, pricing alternatives, and optional services. The permutations of possible costs to be disclosed -- and the potential for error -- also increase. The regulation, too, becomes more complicated, and if the rules are not well understood by creditors, the potential for inaccurate or incomplete disclosures is exacerbated.

The current scene is one of complex rules that attempts to assure accurate information in the face of a complex marketplace. The result is admittedly imperfect; the question is whether another approach would provide improvements significant enough to justify the disruption that would unavoidably accompany any major regulatory or statutory changes.

Some data are available concerning the extent to which consumers use cost disclosures to shop for credit, and what information is most important in making their credit decision. Although somewhat dated (ranging from 1970, shortly after the TILA was enacted, to 1987)

these data suggest that some consumers do shop for credit and are aware of cost disclosures. But interest rates and monthly payments, rather than the finance charge and the APR, remain the key cost disclosures.[3] The data reinforce the views of numerous commenters and some Consumer Advisory Council members who support an APR based on the interest rate and an accompanying itemization of other costs. It could be useful to explore that possibility, although any changes to the TILA should be made only if consumer benefits justify the costs incurred.

The APR translates the dollar amount of the disclosed finance charge into a percentage figure. The APR for open-end credit advertisements and account-opening disclosures solely reflects the cost of interest. The figure is easy to understand and to disclose. The APR that appears on periodic billing statements is a somewhat broader measure. It reflects interest and certain finance charges that typically recur (a transaction fee for cash advances, for example); one-time fees or those associated with originating or renewing a credit line (such as "points" imposed to open a home-secured line of credit) are not included, to avoid a skewed APR during a single billing cycle. For open-end credit, this approach to disclosing the cost of credit is almost mandated by the nature of the product, which typically involves fluctuating balances and account activity.

The APR for closed-end loans includes the interest and certain other charges such as points and required insurance, and is more controversial. There is broad support for improving this APR disclosure, but ideas differ widely on how to go about it. Consumer representatives say that the APR for closed-end credit would be more meaningful if it reflected all costs paid by the consumer, including those currently excluded such as fees associated with real estate-secured loans or premiums for credit life insurance purchased at the consumer's option.

Creditors on the other hand, argue that the current APR figure is not helpful because consumers are confused about the relationship between it and the contract interest rate; consequently, it is often ignored as a shopping tool. Others say the APR does not reflect the economic reality of the credit transaction in the case of home-purchase loans and that an APR based on average time homeowners stay in a home would be more helpful, they believe, than an APR based on a twenty-year loan term, for example.

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[3]Thomas F. Durkin and Gregory E. Elliehausen, *1977 Consumer Credit Survey*, Board of Governors of the Federal Reserve System (December 1978); William K. Brandt and Robert P. Shay, "Public Regulation of Financial Services: The Truth in Lending Act," in Arnold A. Heggestad, ed., *Regulation of Consumer Financial Services*, Abt Associates, Cambridge, Massachusetts (1981); Board of Governors of the Federal Reserve System, *Annual Percentage Rate Demonstration Project*, (Board of Governors (March, 1987).

Changing the APR calculation for home-secured closed-end transactions would have dramatic implications for creditors and consumers. Creditors would face major and immediate costs -- to reprogram computers, create new forms, and retrain personnel. Consumer education would be needed over an extended period to assist consumers in understanding the significance of new disclosures.

**Feasibility of Treating as Finance Charges all Costs of Credit**

The Congress studied the concept of Truth in Lending for several years before the TILA was enacted in 1968. Much of the debate centered on the issue now presented -- what charges properly belong in the dollar and percentage measures of the cost of credit? The scheme that the Congress ultimately adopted sought to approximate "truth" by distinguishing between charges that should be "in" or "out" of the finance charge and the APR.

In the almost thirty years of Truth in Lending experience, this approach has presented compliance difficulties.[4] The Board has issued numerous interpretations trying to match the congressional scheme to a changing marketplace of credit products. The variety of possible charges, the rate at which new products, services, and charges are developed, and the basic difficulty of the "some in, some out" approach, has at times created uncertainty for lenders and exposed them to serious consequences through the courts for missteps in disclosure. It also has produced a complex set of rules with the attendant regulatory burden.

A simpler approach -- such as treating as a finance charge all costs associated with a consumer credit transaction -- has considerable appeal. It comports as well with the view that TILA disclosures should reflect "what the borrower pays." It is straightforward and understandable. Applying a single rule for all charges provides a uniformity that would reduce the likelihood of creditor error and might reduce consumer confusion.

There are problems with this approach, however. Any such major change would be extremely costly in the short run. There are tens of thousands of creditors in the country, engaging in millions of credit transactions annually. All of these transactions would require new forms, computer programs, employee training, and the like. The cost by any measure would likely be many millions of dollars. Thus, the benefits of making the change would need to clearly outweigh those significant expenditures.

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[4]Data indicate that for examinations of state member banks conducted by the Federal Reserve between 1991 and 1995, the finance charge disclosure for closed-end credit was the most common violation of Regulation Z. Data from the Office of Thrift Supervision, Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency indicate, on average, comparable experience.

Including all the costs in the finance charge may in some cases noticeably increase both this figure and the APR. Some creditors could face problems with state usury laws unless those laws are revised. But beyond that, the disclosure of a higher APR could be misleading to consumers and create considerable competitive problems -- if, for example, the higher APRs suggest that credit is substantially more expensive than leasing, or that the consumer is better off drawing down investments and paying in cash.

The current APR is only a rough measure of the cost of credit. To the extent the gap widens between the APR and the interest rate in a transaction, the risk of consumer misuse may be exacerbated. If the concept of the APR were substantially changed from what consumers have known for almost three decades, an extensive consumer campaign of reeducation would be needed to assure public understanding and consumer confidence. Without such a campaign, an immediate jump in APRs might, among other things, falsely suggest a changing rate environment in the economy.

It also is not clear that an all-inclusive finance charge rule is the best approach to achieve the TILA's goal for "meaningful" disclosures at all stages of the credit process and for all product types. A different APR rule might be needed for advertisements. For instance, an all-inclusive approach means that the cost of optional services (such as credit life insurance premiums) should be part of the finance charge and the APR disclosed to consumers before they become obligated for the credit. But an advertised APR that includes the cost of optional services would limit its value for comparison shopping and could be very misleading to many consumers.

Fees imposed by third parties pose special difficulties for presenting accurate and meaningful, all-inclusive finance charge disclosures. These problems are most apparent in real estate-secured loans -- typically the most expensive credit transaction for consumers where the need for complete cost disclosures is greatest. Last-minute negotiations for allocating costs between a buyer and seller, and requests for additional services, are commonplace. Under the current law, many closing costs or fees for services are explicitly excluded from the finance charge; thus, a sudden reallocation of closing costs does not affect the finance charge calculation. Under an all-inclusive approach, these last-minute changes that occur at closing would change the amount of the finance charge. This presents a timing problem, since home-secured loans are often closed by a settlement agent or other third party. The creditor prepares the TILA disclosures -- sometimes from a central processing location -- some days in advance of the closing. If the creditor's disclosures become inaccurate due to these last-minute changes at the loan closing, new disclosures must be prepared. The creditor may lack the capacity to complete and immediately deliver new disclosures while the consumer waits, yet postponing the closing may not be a practical option for the borrower.

**Need for Further Study**

The Board believes it is premature to present recommendations for statutory modifications of the finance charge at this time. Most of the solutions that have been suggested involve dramatic changes to the way the cost of consumer credit is presently disclosed; they would be costly to implement and take considerable resources for consumer education. The comments received from the public serve to establish the wide differences in perceptions regarding the need for change and the best avenues for achieving enhanced consumer benefit without imposing an unduly onerous burden on creditors. For example, including all charges in the finance charge would raise major issues of cost, public understanding, competitive disadvantage, and technical compliance. Any such dramatic change should be approached with caution. In short, the Board believes that further debate must precede the crafting of any proposals for statutory changes to finance charge disclosures affecting the APR.

The issues will benefit from further study and public comment on specific proposals. The Board has targeted for 1997 the initiation of a comprehensive review of the entire Truth in Lending scheme, pursuant to section 303 of the Riegle Community Development and Regulatory Improvement Act of 1994. Searching for a more effective way to calculate the finance charge will be an integral part of that review. The Board will seek further input from its Consumer Advisory Council, and may utilize consumer surveys to target key questions on consumer views that would assist the Board in identifying possible changes to the finance charge disclosure. Indeed, a comprehensive look at the timing and content of all cost disclosures that creditors are required to provide should precede any proposals for statutory changes to the TILA disclosure scheme -- particularly for home-secured loans including disclosures given pursuant to other laws such as the RESPA.

## B. ABUSIVE REFINANCING PRACTICES

**Refinancing and Rescission Rules Under the Truth in Lending Act**

The TILA and Regulation Z allow consumers to cancel (or rescind) certain credit transactions secured by the consumer's home. For example, the right of rescission applies if a consumer's principal dwelling is used to secure a loan financing home improvements or a child's education. Some loans are not rescindable, such as a loan to acquire or construct the dwelling. 15 U.S.C. § 1635; 12 C.F.R. §§ 226.15, 226.23. The typical rescission period is three days after loan closing; generally, loan proceeds may not be disbursed during this period. The right of rescission may be waived by the borrower only for a bona fide personal financial emergency.

If the creditor refinancing the loan is the same creditor that initially extended the credit, a consumer may rescind the refinancing only to the extent new monies are advanced.

For example, if a consumer's principal dwelling secures a loan with a creditor and the consumer seeks to refinance an outstanding balance of $100,000 with the same creditor, the transaction is not rescindable. If the consumer receives an additional $25,000, the refinancing could be rescinded up to that advance. If the consumer seeks to refinance the loan with a new creditor, the entire transaction is rescindable, whether or not new monies are advanced.

The Board's notice on possible changes to the finance charge rules also asked for recommendations on statutory or regulatory changes to address any abusive refinancing practices that creditors may engage in for the purpose of avoiding rescission. Almost forty commenters responded. Many reported being unaware of any abusive refinancing practices by creditors; a few suggested that consumers sometimes abuse their rescission rights by using the threat of rescission to renegotiate a more favorable interest rate. Some offered ideas for modifications to the current rules that ranged all the way from allowing the right of rescission in all refinancings, at one end of the spectrum, to repealing the rescission rules in their entirety, at the other.

Representatives of government agencies and consumer advocates did point to certain practices. They assert that some creditors or settlement agents ask consumers to sign an "Election Not to Rescind" form at closing -- in violation of the rules requiring a three-day wait. Consumer advocates also identify practices involving high closing costs in refinancings that escape the law's protection because the loan is with the same creditor and no "new money" is advanced. Some commenters also discussed "loan-splitting," where a consumer enters into an unsecured loan for a small amount of money, but pays closing costs (such as broker's fees) usually associated with a home-secured loan. Soon after the unsecured loan is made, the creditor "refinances" the unsecured loan and takes a security interest in the consumer's home. Rescinding the new transaction entitles the consumer to a refund of all fees paid in connection with the secured credit -- including fees paid to third parties such as brokers. In this case, however, the broker's fees were part of the unsecured loan, and are not refunded.

**Existing Rules and Possible Modifications**

The right of rescission was intended to protect unsuspecting consumers in credit transactions that could result in the loss of their homes. The remedy was aimed primarily at home-improvement transactions promoted by vendors who pressured low-income consumers into installment contracts. Consumers were using their homes as security for the credit extension, at exorbitant interest rates, without realizing that they stood to lose them if they defaulted on payments. Oftentimes, work was not performed, or it was started and not completed, or consumers were pressured into accepting different terms once the work was begun. Commonly, the credit contracts were assigned to finance companies and others, who at that time had holder-in-due-course protection against consumer claims and defenses that

were based on the actions of original creditor-contractors. Consumers who failed to meet the payment obligations lost their homes.

Although it was the acts and practices of unscrupulous home improvement contractors that provided the impetus for the TILA right of rescission, the scope of the law is broader. All creditors are subject to the rescission rules and all borrowers are generally afforded the protection when their home serves as security for an extension of credit. Borrowers have a three-day "cooling off" period to review loan documentation, reassess their willingness to place their home at risk, and rescind if they wish. If material TILA disclosures provided to consumers are inaccurate, the right to rescind may extend for up to three years after consummation.

The Board considered one aspect of the rescission rules and presented its views to the Congress in early 1995 (prior to the TILA Amendments of 1995), addressing the major concern about the right of rescission.[5] Based on the comments received and its own analysis, the Board believes the problem of creditors engaging in refinancings for the purpose of avoiding a consumer's rescission rights is not widespread. Such practices -- however limited in scope -- are not condoned, and the Board believes existing state and federal laws adequately provide protection against creditors that circumvent the TILA or that engage in unfair and deceptive credit practices. For example, the Home Ownership and Equity Protection Act of 1994 (HOEPA), contained in the Riegle Community Development and Regulatory Improvement Act of 1994, authorizes the Board to prohibit acts or practices in connection with mortgage loans that the Board finds to be unfair, deceptive, or designed to evade the provisions of the HOEPA, and the refinancing of mortgage loans that the Board finds to be associated with abusive lending practices.

The HOEPA also directs the Board to conduct public hearings, the first to be held before September 1997, to examine the home equity loan market and the adequacy of existing law in protecting the interests of consumers, and low-income consumers in particular. Given the limited scope of the problem, the Board believes it is appropriate to defer consideration of any regulatory rulemaking or legislative recommendations until after the hearings are held and more data, if any, are made available.

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[5]Section 344 of the Riegle Community Development and Regulatory Improvement Act of 1994 directed the Board to submit recommendations to the Congress on whether consumers would benefit from having greater flexibility in waiving the right of rescission in transactions with new creditors to refinance or consolidate home-secured loans (where no additional debt is incurred). The Board's report supported such greater flexibility.

**CONCLUSION**

The Board was asked to submit a report to the Congress on how the finance charge could be modified to more accurately reflect the cost of consumer credit, and to address the feasibility of treating as finance charges all costs imposed by the creditor or paid by the consumer as an incident of the credit. Although it may be desirable to change the finance charge definition, the impact of changes in the rules affecting finance charges and the APR would be significant for creditors and consumers alike. The Board believes it is premature to recommend statutory changes at this time without further deliberation and participation from the public about the appropriate approach and consequences of modifying the current law. The Board will consider regulatory revisions consistent with this report in an upcoming review of Regulation Z, under its review of the entire Truth in Lending scheme pursuant to section 303 of the Riegle Community Development and Regulatory Improvement Act of 1994.

The Board was also asked to address abusive refinancing practices that creditors may engage in for the purpose of avoiding a consumer's rescission rights. Anecdotal evidence suggests such practices are quite limited and can be addressed under existing law. Public hearings to be held by the Board in 1997 will provide a forum to gather further information on this issue.