1996 Regulation Z Changes Implement Truth in Lending Amendments Act

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By Alvin C. Harrel

I. Introduction

These changes were prompted by cases like Redish v. AIB Mortgage Co.11 allowing rescission of a mortgage loan on grounds of minor disclosure errors.12 The solution was to provide additional APR disclosure tolerances, to supplement the traditional tolerances of one-eighth of one percent (for regular transactions) and one-fourth of one percent (for irregular transactions),15 and to expand the tolerances for disclosure of the Finance Charge.16 While this relief is undoubtedly welcomed by lenders, and the FRB staff has done its usual competent job of trying to transform legislation into regulations, the complexity of the resulting hierarchy of tolerances detracts somewhat from the value of the changes.

II. New Finance Charge and APR Tolerances

A. Introduction

These changes were prompted by cases like Redish v. AIB Mortgage Co.11 allowing rescission of a mortgage loan on grounds of minor disclosure errors.12 The solution was to provide additional APR disclosure tolerances, to supplement the traditional tolerances of one-eighth of one percent (for regular transactions) and one-fourth of one percent (for irregular transactions),15 and to expand the tolerances for disclosure of the Finance Charge.16 While this relief is undoubtedly welcomed by lenders, and the FRB staff has done its usual competent job of trying to transform legislation into regulations, the complexity of the resulting hierarchy of tolerances detracts somewhat from the value of the changes.

III. Mortgage Loan APR Disclosures

Regulation Z section 226.22(a)13 has been revised to add new paragraphs (a)(4) and (a)(5), covering closed end loans secured by real property or its occupancy. New section 226.21(d)(1) provides a new Finance Charge disclosure tolerance for such loans (generally referred to as mortgage loans) consummated on or after September 30, 1995. For such loans, the Finance Charge disclosed will be considered accurate if it is understated by $100 or less or if it is overstated.17 This new tolerance protects not only the disclosed Finance Charge but also any other disclosure affected by the Finance Charge disclosure. Thus if the Finance Charge disclosure is within these tolerances, a resulting APR disclosure based on the disclosed Finance Charge will also be deemed accurate.18 The FRA Supplementary Information indicates that consumer groups argue this should be limited by a "good faith" error test.19 The FRI rejected this approach on grounds that such a test would be inconsistent with the statutory purpose of reducing litigation, inasmuch as a good faith test would require litigation regarding the correctness of disclosures, leading to potential discrimination against the consumer.20 Closed-end loans other than mortgage loans continue to be subject to the prior tolerance rules.21

IV. New Tolerances for APR Overstatements

Regulation Z section 226.22(a)13 has been revised to add new paragraphs (a)(4) and (a)(5), covering closed end loans secured by real property or its occupancy. New section 226.21(d)(1) provides a new Finance Charge disclosure tolerance for such loans (generally referred to as mortgage loans) consummated on or after September 30, 1995. For such loans, the Finance Charge disclosed will be considered accurate if it is understated by $100 or less or if it is overstated. This new tolerance protects not only the disclosed Finance Charge but also any other disclosure affected by the Finance Charge disclosure. Thus if the Finance Charge disclosure is within these tolerances, a resulting APR disclosure based on the disclosed Finance Charge will also be deemed accurate. The FRA Supplementary Information indicates that consumer groups argue this should be limited by a "good faith" error test. The FRI rejected this approach on grounds that such a test would be inconsistent with the statutory purpose of reducing litigation, inasmuch as a good faith test would require litigation regarding the correctness of disclosures, leading to potential discrimination against the consumer. Specifically, new section 226.22(a)(4)21 provides that an APR disclosure will be deemed accurate if based on the disclosed Finance Charge disclosure that is considered accurate under the new tolerances at section 226.18(d)(1),22 which allow an understatement up to $100 and an unlimited overstatement.23 Again, this is in addition to the other APR tolerances of one-eighth of one percent and one-fourth of one percent at section 226.22(a)(2) and (3).
APR disclosure will be considered accurate if it is within the tolerances provided at section 226.22(a)(4) and (5) for mortgage loans36, but the new tolerances at section 226.23(b) and (h) for Finance Charge disclosures in rescission cases (and the resulting APR) will not be applicable to Section 32 loans.37

II. Additional Tolerance for Mortgage Loans

In addition to the new tolerances discussed above, the FRB has provided a new tolerance not specifically enumerated in the Truth in Lending Act Amendments of 1995, at Regulation Z section 226.20(a)(5). While this tolerance adds complexity to the regulation, it is clearly necessary to avoid anomalous results,38 and will undoubtedly be appreciated as a means to avoid the uncertainty that otherwise would be created.

Section 226.20(a)(5) provides that in addition to the other tolerances noted above, in a transaction secured by real property or a dwelling, if the disclosed Finance Charge is calculated incorrectly but is within the tolerances noted above, the disclosed APR will be considered accurate if:

1. The disclosed Finance Charge is understated, and the disclosed APR is also understated but is closer to the correct APR than it would be if it was based on the disclosed Finance Charge.39

2. The disclosed Finance Charge is overstated, and the disclosed APR is also overstated but is closer to the correct APR than it would be if it was based on the disclosed Finance Charge.40

While neither the purpose nor the effect of these new disclosure tolerances is immediately apparent upon a perusal of the new regulation, the FRB Supplementary Information helps solve the mystery by explaining that this tolerance is intended to cover the situation where the disclosed APR is not based on a Finance Charge disclosure that is erroneous within the allowed limits, yet is more accurate than would be an APR disclosure that is based on such a Finance Charge. In other words, it avoids the anomalous result of a creditor being held liable of disclosing an APR that is more accurate than that allowed by the new tolerances, just because the creditor’s disclose did not make precisely the same error used in calculation of the permitted tolerances. In the words of the FRB Supplementary Information:

"The purpose is to avoid the anomalous result of imposing liability on a creditor for a disclosed APR that is incorrect but is closer to the actual APR than the APR that would be considered accurate under the statutory tolerance in [section 226.20(a)(4)]."

The Supplementary Information also provides an example that illustrates several of the new rules: If a Finance Charge is understated by $100, resulting in an APR that is understated by one-half of one percent, the APR will be deemed correct under section 226.22(a)(4), even though it is outside the one-eighth of one percent or one-fourth of one percent tolerance at section 226.22(a)(3) or (3b), because the APR is based on a Finance Charge that is within the new tolerances provided at sections 226.18(b)(1) and 226.22(a)(4).

Similarly, if in this situation the APR is understated by less than one-half of one percent, it will be considered accurate even though the result does not comport precisely with the new tolerances, because the disclosed APR is more accurate than that required under section 226.22(a)(4).70 To quote the Supplementary Information again:

"[T]his rule treats as accurate, a disclosed APR that is more accurate than the one resulting from a misstated Finance charge that is considered accurate under the 1995 Amendments."41

III. New Tolerances and Other Issues Affecting the Right to Rescind

A. Recission Forms

Presumably in response to cases like Porter v. Mid-Penn National Co.,42 the revised Regulation Z clarifies that use of a new model APR model right of rescission form (or a comparable form) will constitute compliance with the rescission notice requirement.43 Model form H-9 was revised to improve its usefulness and to clarify that any financing with the original creditor, whether or not the creditor is the holder of the note at the time of refinancing,44 the form was also revised to clarify its use when the original note and mortgage are discharged and released and new documents are executed to evidence the old debt and cover an advance of new funds.45 While one might have hoped for still greater clarification in the context of a Porter v. Mid-Penn National Co.46 situation, there can be no doubt that Regulation Z has been improved as regards these issues.

B. Tolerance for Recission Purposes

Revised Regulation Z recognizes new and old disclosure tolerances for creditors faced with a consumer’s effort to rescind a mortgage loan, based on sections 106(1)(a) and (2) of the Truth in Lending Act.47 The FRB rejected efforts to condition the new tolerances on a "good faith" test.48 Revised Regulation Z provides a new tolerance for disclosure of the Finance Charge and other disclosures affected by the Finance Charge disclosures (such as the amount financed and APR).49 Revised section 226.23(g) provides that these disclosures will be considered accurate for rescission purposes if the disclosed Finance Charge is understated by no more than one-half of one percent of the face amount of the notice or $100, whichever is greater, is overstates.45

In a refinancing of a residential mortgage loan with a new creditor other than the one under a Section 12 loan,46 if there is no new money advanced and no consolidation of other loans,56 the disclosures will be considered accurate if the Finance Charge is understated by no more than one percent of the note amount or $100, whichever is greater, or is overstates.57 These tolerances are significantly greater than the old tolerances of $5 (for an amount financed up to $1,000) and $10 (for an amount financed over $1,000).58

If the right of rescission is asserted after foreclosure has been initiated, a lump sum offer is allowed, apparently on the theory that a consumer in foreclosure deserves a higher level of protection than a non-defaulting consumer.59 The revisions also allow a consumer in foreclosure to rescind on grounds a mortgage broker fee was not properly disclosed, regardless of the dollar amount.60

Under new section 226.23(c),61 after initiation of a foreclosure action on the consumer’s principal residence, the Finance Charge and related disclosures (e.g., the amount financed and APR) will be considered accurate for rescission purposes only if understated by no more than $35 or if overstatements. Revised section 226.23(c)62 provides that any of these errors may permit a consumer in a home mortgage foreclosure to rescind:

- Failure to include a required mortgage broker fee in the Finance Charge.63
- Failure to use an appropriate rescission form.64
- Disclosures outside the tolerances noted above.65

IV. Summary of 1996 Regulation Z - Revisions of Disclosure Tolerances

A. Revised Finance Charge Disclosure Tolerances

In a loan secured by real property or a dwelling, the disclosed Finance Charge and other disclosures affected by the Finance Charge disclosure (including the amount financed and APR) will be deemed accurate if the finance charge disclosures (including the amount financed and APR) were not disclosed accurately by no more than $100, or by more than the amount required to be disclosed. There are separate new tolerances for Finance Charge disclosures on the right of rescission, depending on whether the loan is in foreclosure (see below).

B. Revised APR Disclosure Tolerances

Revised Regulation Z provides new tolerances for APR disclosure errors based on incorrect finance charge disclosures. Generally, Regulation Z recognizes an APR disclosure toleration of one-eighth of one percent (one-fourth of one percent in an "irregular" transaction). However, for finance charge disclosures, new Regulation Z additionally treats APR disclosure errors resulting from inaccurate Finance Charge disclosure as accurate if:

- The APR results from the disclosed Finance Charge, and the...

36. 12 C.F.R. § 226.20(a)(5).
37. 12 C.F.R. § 226.20(a)(5).
38. See supra, II. C. 1.
40. See supra, II. C. 1.
41. 12 C.F.R. § 226.21(b)(4). See also supra, II. C. 1.
42. Porter v. Mid-Penn National Co., 731 F.2d 51 (3rd Cir. 1984).
43. 12 C.F.R. § 226.21(b)(4).
44. For the model APR of the Partnership for Legal Action Against Credit Discrimination, see supra, II. C. 1.
45. 12 C.F.R. § 226.23(c).
47. 12 C.F.R. § 226.23(c).
48. 12 C.F.R. § 226.21(b)(4). See also supra, II. C. 1.
49. 12 C.F.R. § 226.23(c).
50. 12 C.F.R. § 226.23(c).
51. See supra, II. C. 1.
52. 12 C.F.R. § 226.23(c).
53. See supra, II. C. 1.
54. 12 C.F.R. § 226.23(c).
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64. 12 C.F.R. § 226.23(c).
65. 12 C.F.R. § 226.23(c).
66. See supra, II. C. 1.
67. 12 C.F.R. § 226.23(c).
68. 12 C.F.R. § 226.23(c).
69. 12 C.F.R. § 226.23(c).
70. 12 C.F.R. § 226.23(c).
Finance Charge disclosure would be considered accurate because it is an over-disclosure or is under-disclosed by $100 or less; or

• The APR results from a disclosed finance charge that is within the tolerances for rescission purposes (generally one-half of one percent of the note or $100, whichever is greater, for under-disclosure if the loan is not in foreclosure; one percent or $100, whichever is greater, for a refinancing of a residential mortgage transaction with a new creditor and no new advances or consolidation if the loan is not in foreclosure; $35 for under-disclosure if the loan is in foreclosure); or

• The APR results from an incorrect Finance Charge disclosure and the APR disclosed is higher than the correct APR; or

• The APR is more accurate than the tolerances noted above, even if not based on the incorrect finance charge disclosure.

V. Mortgage Broker Fees

Fees charged by a mortgage broker and paid by the consumer must be included in the Finance Charge, whether paid directly to the broker or through the creditor, even if the creditor did not require use of a mortgage broker or retain any part of the fee. Such fees are excluded only if they would be excludable if charged by the creditor or if charged to all loan applicants regardless of whether credit is granted. Such fees must also be disclosed at closing on the HUD-1 form.

VI. Settlement Charges

Fees charged by a closing agent that conducts the loan closing are to be included in the Finance Charge only if the creditor requires the service or the charge, or retains part of the fee (in the latter case only that portion is includable).

VII. Conclusion

As noted above, these revisions reduce the likelihood that a minor error will constitute a Truth in Lending violation, but at the cost of added complexity in the law and regulation. In this sense the revisions reflect the challenges and frustrations of efforts to reform American consumer credit law.

About Face: Yield Spread Premiums
Not Necessarily Illegal

By Leonard A. Bernstein*

On January 10, 1997, federal District Court Judge Bryan in Alexandria, Virginia shook the residential mortgage industry by writing an initial opinion in the Mentecki v. Saxon Mortgage, Inc. class action stating that "the payment of a yield spread premium is a referral fee prohibited by RESPA." RESPA refers to the federal Real Estate Settlement Procedures Act, which prohibits the payment of referral fees and kickbacks among providers in the residential finance industry. A yield spread premium is a common form of lender payment to a mortgage broker.

News of this adverse RESPA decision spread like wildfire in both the lending industry and general press. Now, however, it is time to stop the presses.

On February 7, 1997, Judge Bryan granted a lender's motion for clarification, significantly changing his prior conclusion. The motion was prepared in large part by Reed Smith Shaw & McClay on behalf of one defendant. Judge Bryan agreed with Reed Smith and its client that the Judge's January 10, 1997 decision "perhaps went further than strictly required....Certainly the court has not reached a final decision about the legality of yield spread premiums, nor was the order of January 10, intended to suggest this."

The February 7, 1997 opinion by Judge Bryan is a much needed victory for residential mortgage bankers and brokers. The January 10, 1997 opinion and its unfortunate language suggesting that yield spread premiums are illegal referral fees had threatened to seriously damage the residential mortgage market by triggering an outbreak of yield spread premium RESPA class action litigation.

Plaintiff class action counsel had been riding the Mentecki firestorm by racing to find representative plaintiffs so they could bring additional yield spread class action lawsuits. Now, thanks to Judge Bryan's wise revision and clarification of the January 10, 1997 opinion, these plaintiff's lawyers should think twice. Not only are yield spread premiums not declared illegal at this point, a recent

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* Mr. Bernstein is a partner in the New Jersey office of Reed Smith Shaw & McClay and is a member of the firm's RESPA Litigation Team. He is a member of the Governing Committee of the Conference on Consumer Financial Law.


2. Id. Order (reconsidering defendant’s motion for reconsideration) (Feb. 7, 1997).