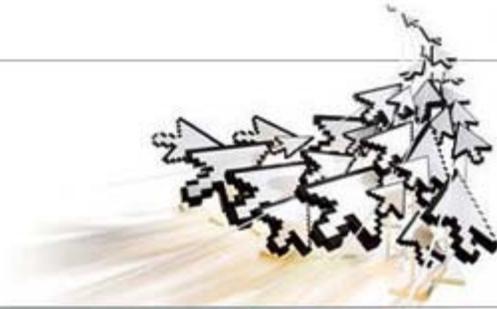


## Financial Institution Compliance Update



**March 4, 2014**

*This communication is designed to provide you with quick snapshots and timely perspective on recent regulatory developments.*

### **Regulation Z: What you need to know about Finance Charge Calculations and How to Avoid Costly Liability.**

Regulation Z has had various changes over the last couple of years, but one area within Regulation Z that has not changed but continues to get significant scrutiny from the regulators is the disclosure and calculation of Annual Percentage Rate (APR) and finance charges. The following is additional guidance on these disclosures and calculations as they pertain to closed-end residential mortgage loans.

#### **Definition of a Finance Charge**

A finance charge is a cost of credit, either interest or a fee charged for the use of credit, or the extension of existing credit. Generally, a cost that would have been incurred in a cash transaction with no borrowing involved (e.g., the cost of recording the deed from seller to buyer) is not a finance charge.

The definition of "finance charge" is in Regulation Z, 12 CFR 1026.4. This definition includes specific examples of what is or is not a finance charge. Some of the specific examples are counterintuitive. For example, the cost of recording the lender's mortgage, imposed on the borrower, is by definition, not a "finance charge" even though that is a cost of obtaining credit from the lender.

Very little has changed in the definition of finance charge over the years. Recent regulatory promulgations and proposals by the Consumer Financial Protection Bureau, including the final TILA-RESPA rule issued on November 20, 2013 and effective in 2015, do not alter the definition or examples of finance charges previously enacted.

#### **How to Calculate a Finance Charge**

In the typical transaction, the total finance charge is the sum of finance charges paid at or before closing ("prepaid finance charges") plus the interest that is expected to be paid over the course of the loan. Sometimes there are other finance charges that are paid over the course of the loan. The most common example of this is escrow for mortgage insurance – a finance charge – that will be paid over all or, more likely, part of the loan. The treatment of mortgage insurance will be

discussed further below. All prepaid finance charges should be among the settlement charges itemized on the HUD-1 settlement statement.

Determining the total interest expected to be paid during the course of the loan requires reference to a payment schedule. Items that should be considered as part of this payment schedule include:

- *Fixed-rate closed-end loan (with no mortgage insurance)*  
In this case, the total of interest paid is just the sum of the principal-plus-interest ("P + I") payments minus the face amount of the loan. If there are escrows for real property taxes or homeowners insurance, those components are disregarded for purposes of finance charge calculation since those items are not finance charges.
- *Variable-rate closed-end loan (with no mortgage insurance)*  
To compute the amount of interest to be paid, the lender must construct a payment schedule using assumptions permitted and required by Regulation Z. The initial payment stream will be the initial P + I monthly payment amount for the number of months until the first interest rate change date. For purposes of finance charge calculation, the lender assumes that (1) the index defined in the note will be the same on the first change date as it is on the closing date, and (2) the interest rate resulting from that assumption will remain unchanged from the first change date until the end of the loan. The P + I payment resulting from those assumptions is used for the life of the loan, as if the loan was a fixed-rate loan from the first interest rate change date forward.
- *Loans with mortgage insurance*  
For loans where the borrower's monthly payment is to include an escrow for mortgage insurance, the total finance charge is calculated using the principal + interest + mortgage insurance ("P + I + MI") component of the borrower's monthly payment. However, for purposes of the calculation, the lender is to assume that the mortgage insurance escrow will stop when the loan-to-value ratio reaches the level where mortgage insurance may no longer be collected. Here, the lender uses the mortgage insurance disclosure and amortization table required by the Homeowners Protection Act to forecast when mortgage insurance will be automatically terminated and the mortgage insurance component of the monthly payment reduced to zero.

### **Guidelines for Using APRWIN Tool to Calculate APR**

The Office of the Comptroller of the Currency created the "Annual Percentage Rate Calculation Program for Windows" – APRWIN – which incorporates the complicated instructions of Regulation Z – Appendix J. The OCC has made APRWIN available to the general public; APRWIN may be downloaded at <http://www.occ.gov/tools-forms/tools/compliance-bsa/aprwin-software.html>. With the APRWIN tool, a user may calculate the APR and Finance Charge for a closed-end mortgage loan and/or check the accuracy of the APR and Finance Charge disclosures on the Truth in Lending Disclosure Statement (the "TIL") for a loan. APRWIN does not identify what closing charges are or are not finance charges. It's up to the user of the tool to identify the prepaid finance charges and calculate the total thereof and the "Amount Financed" (loan amount minus total of prepaid finance charges).

The information required to run an APRWIN calculation for a closed-end resident mortgage loan includes:

- The "Amount Financed" which is the loan amount minus total of prepaid finance charges.

- If checking the accuracy of a preliminary or final TIL, the disclosed APR and finance charge.
- The number of odd days refers to the number of days between the closing date and the 1st of the following month. Typically a mortgage loan has payments on the 1st of the month. If, as usual, the settlement or disbursement date occurs mid-month, the borrower is charged interest on a per diem basis from settlement or disbursement to the first of the next month. The time period and the amount of "odd – days interest" is reported on line 901 of the HUD – 1 Settlement Statement.
- The amount and number of payments from the payment schedule is explained in the following example: For a typical fixed-rate 30-year loan, the payment schedule would consist of 359 payments of X dollars and a 360th payment in an amount close to X. APRWIN describes this as a first "payment stream" of 359 payments and a second "payment stream" of one payment. In the case of a variable rate loan or a loan with escrowed mortgage insurance, there might be three or more payment streams.

### **APR and Finance Charge Reporting Accuracy and Tolerance Levels**

To ensure reporting accuracy, it is important to note specific requirements in Regulation Z relating to disclosing finance charges and APR found in the following sections:

- Section 1026.18 (d)(1) – the disclosed finance charge shall be treated as accurate if the amount disclosed as the finance charge is; a) understated by no more than \$100; or b) greater than the amount required to be disclosed.
- Section 1026.22 (a) (2) – "As a general rule, the annual percentage rate shall be considered accurate if it is not more than 1/8 of 1 percentage point above or below the annual percentage rate determined in accordance with [Regulation Z]."

### **Consequences of a disclosure violation**

In addition to the other liabilities and remedies provided by the Truth in Lending Act and Regulation Z, Section 108 of the Act (15 U.S. Code 1607) authorizes certain federal agencies such as the FDIC to require banks or other entities under their jurisdiction to reimburse consumers in the event of finance charge or APR errors. 15 U.S.C. 1607(e)(1) provides:

- "In carrying out its enforcement activities under this section, each agency...is authorized...to require the creditor to make an adjustment to the account of the person to whom credit was extended, to assure that such person will not be required to pay a finance charge in excess of the finance charge actually disclosed or the dollar equivalent of the annual percentage rate actually disclosed, whichever is lower."
- The foregoing is subject to the \$100 and 0.125% tolerances discussed above, and is subject to limited agency discretion to grant the creditor a waiver. Nevertheless, the possibility of an agency-required "adjustment" can be a large financial consequence of a Truth in Lending disclosure violation.

### **Steps you can take to avoid costly liability:**

We recommend that you invest the time and effort to revisit these processes to avoid costly clean up and remediation of customers. Specifically, here are some measures lenders can take to avoid or mitigate Truth in Lending Act liability:

- Conduct regular quality control of closed loans and maintain upgrades of all applicable systems.
- Re-examine processes for calculating total finance charge, including the process for determining which settlement costs are or are not finance charges.
- Use APRWIN to check the calculation of APR and total finance charge in a sample of closed loans and try to identify the root causes of errors. Be sure to reference the section above that provides guidelines for using this tool.

- Retrain closers or other individuals who are misapplying procedures.
- Remediate any discovered errors by notifying the consumer and providing reimbursement for overcharges.

If you have any issues or concerns with these steps, contact an Experis representative. We have a team of professionals experienced in working with clients to address these issues and avoid costly fines and penalties.

If you have specific questions regarding the regulatory content and commentary of this message, please contact [knowledge@experis.com](mailto:knowledge@experis.com).

