II. Finance Charges

Definition

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

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

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

Annual percentage rate

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

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

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

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

Request for Comment

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

The 1995 Amendments contain, for the most part, provisions affecting closed-end credit that is real estate- or home-secured. The Board believes that the scope of the report is intended to cover the treatment of costs as finance charges for *all* types of consumer credit, although a focus of the study will be on those fees associated with real estate lending that are currently excluded from the finance charge. For example, many costs associated with entering into home-secured loans are the same whether the credit is an installment loan or a line of credit. Similarly, certain application fees are excluded from the finance charge for all types of credit transactions, not just those affecting installment loans.

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

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

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

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