15 Mortgage Loans

This chapter explores the role of the real estate licensee in arranging loans, or sales of loans, secured by real property. It also discusses the federal Truth in Lending Act and Regulation Z.

NOTE: *Unless otherwise stated, "Department" means the Department of Real Estate and statutory references are to sections of the Business and Professions Code.*

BROKER'S ROLE

Mortgage brokers may negotiate loans for property owners who are unable to obtain financing from more conventional sources. A broker negotiates such a loan through a private lender. The phrase "hard money" means cash, as opposed to a loan for the purchase of a property.

THE LOAN APPLICATION

A broker negotiating a loan must obtain information from the applicant which the broker knows will be required by the private lender, including the borrower's ability and willingness to repay the loan. Knowing a lender's guidelines serves the interests of both the lender and the borrower. Those contemplating brokering loans must ascertain the policies and guidelines of their prospective investors.

The following is the type of information the broker will need:

1. Address of the property.
2. Requested loan amount and purpose of the loan.
3. Is the property currently owned or is it being purchased?
4. If being purchased, the purchase price; if currently owned, borrower's estimate of value.
5. How long owned?
6. The vested ownership of the property.
7. Is the property encumbered? What are the loan balances, payment amounts and names and addresses of lenders.
8. Any assessment or unpaid taxes?
9. Any other liens?
10. Borrower's income and debts.

A standard FNMA/FHLMC or similar loan application will usually elicit the necessary information. A credit report and property appraisal will also be necessary.

ADVANCE FEES

A broker may wish to collect money in advance from a loan applicant to cover the cost of services to be performed in arranging the loan. Money collected "up front" is an advance fee. An advance fee may only be collected pursuant to an agreement previously approved by the Department of Real Estate. Commissioner's Regulation 2970 sets forth the basic contents of an advance fee agreement. The broker must also submit, for the Department's prior approval, all advertising materials used in conjunction with an advance fee arrangement.

Any real estate broker who contracts for or collects advance fees from a principal must deposit the funds into a trust account. Advance fees are not the broker's funds. Amounts may be withdrawn for the benefit of the broker only when actually expended for the benefit of the principal or five days after verified accounts have been mailed to the principal. If advance fees are not handled in accordance with the Real Estate Law, it will be presumed that the broker has violated Penal Code Sections 506 and 506a. Penalties and fines may result.

The Department does not treat as advance fees funds collected in advance for appraisal and credit reports as long as the broker collects as near as possible the exact amount(s) necessary and refunds any excess as soon as it is identified. Though not treated as advance fees, these funds ***are*** trust funds.

TITLE POLICY FOR LENDER

A primary concern is that the borrower has good title to the real property which would secure the loan. Once a lender decides that serious consideration can be given to a loan application, the lender will usually request a preliminary report from a title insurance company. This "prelim" includes:

1. a description of the property;
2. the owner of record;
3. taxes, bonds and assessments then owing;
4. reference to recorded covenants, conditions and restrictions affecting the property; and
5. certain other "exceptions" which will not be insured and, therefore, often must be cured before the loan will be granted.

When all objections to title are resolved to the satisfaction of the lender, a title policy insuring the interest of the lender must ordinarily be obtained before the loan is funded. In this policy, the title insurer guarantees to defend the lender against actions founded upon claims of encumbrances or title defects which were known, or should have been discovered, by the title insurer when the policy was issued.

USURY

A loan, arranged extension, forbearance, or refinancing of a loan in which a broker had originally been compensated (even though not being specifically compensated for arranging new credit terms), secured in whole or in part by a lien on real property and made or arranged by a licensed real estate broker is exempt from the usury law. Private individuals making such loans without a broker are controlled by the usury law.

ARTICLE 5 - THE LENDER

The Real Estate Law imposes certain duties and restrictions on real estate licensees who broker mortgage loans or, as either principal or agent, buy, sell or exchange existing promissory notes secured by real property or existing real property sales contracts. Since trading in real property sales contracts is relatively rare, this chapter generally focuses on the deed of trust as a security device. Virtually everything said about the purchase, sale and exchange of loans secured by real property is true with respect to real property sales contracts.

For the sake of simplicity, the phrase "promissory note secured by a deed of trust" is frequently abbreviated to "deed of trust" or "trust deed."

Application of Article 5

The passage of Proposition 2 in November 1979 eliminated interest rate limits on real property loans “made or arranged” by real estate brokers. The Legislature responded in 1981 and 1982 by extensive additions to the Real Estate Law, specifically to Articles 5 (Transactions in Trust Deeds and Real Property Sales Contracts) and 7 (Real Property Loans).

Article 5 (Sections 10230 - 10236.2) is basically applicable to brokering either the funding of mortgage loans by private, noninstitutional investors or the buying, selling or exchanging of trust deeds on behalf of private, noninstitutional investors. The provisions of Article 5 apply also to real estate licensees who engage as principals in buying from, selling to or exchanging deeds of trust with the public, and to brokers who make agreements with the public for the collection of payments or the performance of services in connection with deeds of trust.

Pooling of Loan Funds

Banking or pooling of lenders’ or purchasers’ funds, commonly referred to as multi-lender or fractionalized loans, is prohibited except as authorized by permit issued pursuant to the provisions of the Corporate Securities Law which is administered by the Department of Corporations. A multi-lender loan may be exempt under Corporation Commissioner’s Regulation 260.105.30. Before arranging any multi-lender loan or pooling investor funds, a broker should contact the Department of Corporations.

Advertising

Section 10235 proscribes false, misleading or deceptive advertising by a real estate licensee engaged in the business of brokering loans or the sale of existing trust deeds. An advertisement cannot imply a yield or return on a promissory note different from the interest rate of the note itself unless the advertisement sets forth both the actual interest rate and the difference (discount) between the outstanding principal balance of the note and the price at which it is being offered for sale.

Article 5 also prohibits a real estate licensee from offering or advertising any premium, gift or other inducement to a prospective note purchaser, borrower or lender. (Section 10236.1) The Department does not consider rebates or reductions in the costs and fees of the loan to be a violation. For example, a broker can offer free appraisals as long as no other fees or costs are increased to allow for this inducement.

Real Estate Commissioner’s Regulation 2848 implements the statutory provision against false, misleading or deceptive advertising in areas of mortgage loan brokerage and the marketing of trust deeds. A broker must also disclose license status and regulatory agency in all advertising for loans. A disclosure of “Real Estate Broker, CA. Dept. of Real Estate” in a broker’s mortgage loan advertising complies. (Regulation 2847.3)

Exception to Article 5 Requirements

The provisions of Article 5 do not apply to negotiation of a loan or sale or exchange of a trust deed by a real estate licensee in connection with a real property sale or exchange transaction in which the broker acted as an agent, unless the broker also had a direct or indirect monetary interest as a party.

“Threshold” Criteria

Except as otherwise provided in the law, a real estate broker, acting as agent for others, meets the “threshold” criteria if he/she intends or expects in any 12-month period to do any of the following:

1. Negotiate any combination of 10 or more of the following transactions pursuant to subdivision (d) and (e) of Section 10131 or Section 10131.1 in an aggregate amount of more than $1,000,000:
    a. loans or sales of real property sales contracts or promissory notes secured by liens on real property or on business opportunities;
    b. as the owner, the sale or exchange of real property sales contracts or promissory notes secured by liens on real property or business opportunities; or
2. Make collections of payments in an aggregate amount of $250,000 or more on behalf of owners of promissory notes secured directly or collaterally by real property or owners of real property sales contracts; or
3. Make collections of payments in an aggregate amount of $250,000 or more on behalf of borrowers on promissory notes secured directly or collaterally by liens on real property or lenders (sellers) on real property sales contracts.

A threshold broker must notify the Department in writing within 30 days that the broker meets the threshold criteria. Failure to inform the Department may result in a fine of up to $10,000 and license revocation.

A broker who meets the threshold criteria must file with the Department an annual report within 90 days after the end of the broker's fiscal year and a quarterly trust fund status report within 30 days after each of the broker's first three fiscal quarters.

Loans or sales negotiated by a broker, or for which the broker collects payments, are not counted in determining whether the broker meets the threshold criteria if the lender or purchaser is an institutional lender or if the loan or sale is under the authority of a securities permit issued by the Department of Corporations. Generally speaking, only those brokers dealing with private investors and small pension trusts will satisfy the threshold criteria. (Section 10232)

Disclosure Statement

Sections 10232.4 and 10232.5 require that a real estate broker furnish a non-institutional lender or purchaser of a trust deed with a disclosure statement setting forth:

1. the loan terms;
2. pertinent information about the borrower (identity, occupation, income, credit data, as represented to the broker by the prospective borrower);
3. pertinent information about the property which will secure the loan, including address or other means of identification, fair market value, age, size, type of construction and description of improvements;
4. provisions for loan servicing;
5. pertinent information concerning all encumbrances which are currently liens against the property and which the borrower discloses as prospective liens.

The statement must be delivered before the lender (or purchaser of a note) becomes obligated to complete the loan (or purchase).

A real estate broker who advertises for or solicits funds from the public that are to be used for the broker's direct or indirect benefit must submit the format of the disclosure statement to the Department prior to any solicitation and then an individual statement to each prospective lender or purchaser before the broker accepts any funds from the person solicited. (Section 10231.2)

Disbursing Funds

Unless a lender has given written authorization to the broker, the broker may not disburse loan funds until after recording the trust deed which conveys the property to a trustee as security for the loan. If the lender has given the broker authority to release funds prior to recordation, the securing trust deed must be recorded, or delivered to the obligee with a written recommendation for immediate recordation, within ten days following disbursement of loan funds. The broker is similarly responsible for the execution and recordation of the assignment of a real property sales contract or deed of trust when the sale of the contract or trust deed has been negotiated by the broker.

Servicing - Broker Advances

A real estate broker servicing a note or contract may advance his or her own funds to protect the security of the note being serviced, including an advance to pay debt service on a senior note secured by the same real property. If the broker does advance funds for taxes, hazard insurance or debt service on a senior note secured by the same real property, the broker must, within ten days, give written notice of the advance to the beneficiary of the note being serviced. (Section 10233.1)

Retention of funds. If a broker receives funds from the obligor (borrower) in payment of a promissory note or contract, as is ordinarily the case when servicing the note or contract for the obligee (lender), the broker may not retain the funds for more than 25 days without written authorization from the obligee. The authorization from the obligee may not provide for payment of interest to the broker on funds retained by the broker. Moreover, the agreement between the broker and the obligee (or obligor) authorizing the broker to service the instrument must be in writing.

Commissioner's Regulations

Real estate licensees active in the mortgage loan business should be familiar with Commissioner's Regulations 2845 (interpretative opinion request); 2846 (approved lender/purchaser disclosure statement); 2846.5 (report of annual trust fund accounts review); 2847, 2847.3 and 2848 (advertising); and 2849.01 (annual report format).

ARTICLE 7 - THE BORROWER

The Real Estate Law has long required the licensing of one who negotiates, for another and for compensation, a loan secured by real property. The statutory scheme now found in Article 7 of Chapter 3 (Sections 10240 - 10248.3) was enacted to curb a variety of abuses: exorbitant commissions; inflated costs and expenses; short term loans with large balloon payments; and misrepresentation or concealment of material facts by licensees negotiating loans. Article 7 is variously referred to as the Real Property Loan Law, the Mortgage Loan Brokers' Law and the Necessitous Borrowers' Act.

Application of Article 7

Except for the disclosure statement requirement, Article 7 applies only to loans secured by real property which includes a dwelling. For this purpose, a dwelling is a single dwelling unit in a condominium or cooperative or a parcel containing only residential units if the total number of units on the parcel is four or less. (Sections 10240.1 and 10240.2)

Except for its disclosure statement, late charges, and loan prepayment provisions, Article 7 applies only to first trust deed loans under $30,000 and junior trust deed loans under $20,000. (Section 10245)

Article 7 applies only to loans made or negotiated by real estate brokers acting within the meaning of subdivision (d) of Section 10131 (the basic definition of a real estate broker) or subdivision (b) of Section 10240. Subdivision (b) of Section 10240 brings under Article 7 loan transactions in which a broker solicits a borrower with express or implied representations that the broker will arrange a loan as an agent but in fact makes the loan with the broker's own funds.

Mortgage Loan Disclosure Statement

The Mortgage Loan Disclosure Statement is at the heart of Article 7. The statement's purpose is to provide a prospective borrower with information concerning the important features of a loan.

A real estate broker negotiating, or, under the circumstances described above, making, a mortgage loan of any kind or in any amount to be secured directly or collaterally by a lien on real property must present a completed Mortgage Loan Disclosure Statement to the prospective borrower within 3 days of receipt of a completed written loan application or before the borrower is obligated to take the loan, whichever is earlier. A broker (or, of course, a salesperson employed by the broker) must obtain the borrower's signature on the statement prior to the time that the borrower becomes obligated to complete the loan. In addition, if the loan is subject to Article 7, the licensee must certify in the statement that the loan complies with Article 7.

Section 10241 sets forth the information that must be included in the statement. The form of the statement must be approved by the Commissioner prior to its use. The Commissioner has established two approved forms in Regulations 2840 and 2840.1. RE Forms 882 and 883 can be obtained at any Department office.

The disclosure statement set forth in Commissioner's Regulation 2840.1 is believed to satisfy the disclosure requirements of the federal Real Estate Settlement Procedures Act.

Broker-controlled funds. Both forms of the Mortgage Loan Disclosure Statement provide for disclosure that the broker anticipates that the loan will be made with broker-controlled funds. The phrase "broker-controlled funds" means funds owned by the broker, by the broker's spouse, child, parent, grandparent, brother, sister, father-in-law, mother-in-law, brother-in-law or sister-in-law, or by any entity in which the broker alone or together with any of the above relatives has an ownership interest.

Disclosures - Case Law

In *Realty Projects, Inc. v. Smith* (1973 32 C.A. 3d 204), the court held that the statutory obligation of a licensee to act fairly and honestly demanded that the licensee inform prospective borrowers of the difference between commissions and other charges for loans in amounts subject to the Real Property Loan Law as against loans not covered by that law. While the court referred to the respondent/licensee as the agent of a prospective borrower, the court did not rely upon an agency theory in reaching its decision regarding the disclosure duty. Rather, the duty was declared to stem simply from the respondent's status as a licensee.

In the case of *Wyatt v. Union Mortgage Co.* (1979 24 C.A. 3d 773), the court held that a mortgage loan broker's duty to disclose information about late charges and the effective interest rate of a loan was based upon a fiduciary relationship between the broker and the prospective borrower.

Commissions and Other Charges

Article 7 limits the amount that may be charged as commission or fees for arranging or making a loan and as "costs and expenses" of making the loan. (Again, these limitations do not apply to a first loan of $30,000 or more or a junior loan of $20,000 or more.) The maximum commissions for loans subject to Article 7 are:

1. First loans:
   a. 5 percent of the principal of a loan of less than 3 years;
   b. 10 percent of the principal of a loan of 3 years or more;
2. Second or other junior loans:
   a. 5 percent of the principal of a loan of less than 2 years;
   b. 10 percent of the principal of a loan of at least 2 years but less than 3 years;
   c. 15 percent of the principal of a loan of 3 years or more.

Costs and expenses of making a loan subject to Article 7, including appraisal fees, escrow fees, notary and credit investigation fees (but excluding actual title charges and recording fees) charged to a borrower cannot exceed 5 percent of the loan or $390, whichever is greater, to a maximum of $700. The amount charged cannot exceed the actual costs and expenses paid, incurred or reasonably earned. No charge can exceed the amount customarily charged for the same or comparable service in the community where the service is rendered. (Regulation 2843)

Balloon Payment

A balloon payment is defined as an installment payment that is greater than twice the amount of the smallest installment payment required by the promissory note.

Generally, no loan subject to Article 7 may have a balloon payment if the term of the loan is less than 3 years.

If the property securing the loan is an owner-occupied dwelling, a balloon payment is not permissible if the term of the loan is 6 years or less. As in the case of the 3-year balloon payment provision, the restriction does not apply to a promissory note given back to the seller by the purchaser of the dwelling place on account of the purchase price.

The Mortgage Loan Disclosure Statement includes a notice regarding balloon payments. Section 10241.4 requires an expanded disclosure if provisions have been made, or will be sought, for extension, refinancing or renegotiation of an Article 7 loan which includes a balloon payment.

Other Restrictions

Other restrictions on loans subject to Article 7 include:

1. A mortgage loan broker is prohibited from charging or negotiating any loan servicing or loan collection fee to be paid by the borrower.
2. A borrower may not be required to purchase credit life or credit disability insurance as a condition of obtaining a loan.
3. A licensee may collect only one premium for credit life or credit disability insurance provided through duly licensed agents. Only borrowers whose earnings are reasonably relied upon by the lender for repayment of the loan may be insured.

4. Regardless of the amount of the loan, charges for late payment of an installment are limited to 10 percent (or $5, whichever is greater) of the principal and interest part of the installment payment. If a payment is made within ten days of its due date, no late charge may be imposed.
5. Regardless of the amount of the loan, the penalty that may be charged to a borrower for prepayment is limited if the security for the loan is a single family, owner-occupied dwelling. No charge may be assessed for a prepayment made more than seven years from the date of the loan. During the first six years of the loan, twenty percent of the principal balance of the loan may be paid off during any 12-month period without penalty. The maximum prepayment penalty allowed is six months' interest on the amount prepaid above 20 percent of the unpaid principal balance. This provision applies to loans of any dollar amount if negotiated by a real estate licensee for compensation.
6. The term of an exclusive right to secure financing cannot exceed 45 days.

TRUTH IN LENDING ACT

The Truth in Lending Act (hereinafter, the Act) became effective July 1, 1969. The principal purpose of the Act is to promote the informed use of consumer credit by requiring creditors to disclose credit terms in order to enable consumers to make comparisons between various credit sources. To implement the Act, the Board of Governors of the Federal Reserve System issued a regulation known as Regulation Z.

After a decade of experience with the Act and Regulation Z, it became clear that the requirements placed too great a burden on creditors, provided too many disclosures for consumers, and fostered too much litigation. This prompted Congress to amend the Act in 1980 by passing the Truth in Lending Simplification and Reform Act. To reflect the amendments to the Act the Federal Reserve Board substantially revised Regulation Z. Compliance with the simplified Act and revised Regulation Z became mandatory on October 1, 1982.

At the time revised Regulation Z was promulgated, the Federal Reserve Board adopted model disclosures for closed-end transactions such as purchases of real property, and model language for certain other disclosures. The Board also announced that its staff would no longer provide written responses to individual requests for interpretations of the Regulation, but would issue a staff commentary from time to time to address questions of interpretation.

Creditor

The creditor is responsible for furnishing Truth in Lending disclosures to the consumer. Regulation Z defines a creditor as a person who extends consumer credit more than 25 times a year or more than 5 times a year for transactions secured by a dwelling. The credit extended must be subject to a finance charge or be payable by written agreement in more than four installments. Another requirement that must be met to render a person a creditor is that the obligation be initially payable on its face or by agreement to that person.

In its definition of "creditor," revised Regulation Z included "arranger of credit," which it defined as a person who initially arranged for the extension of credit by persons who did not meet the "creditor" definition. The Federal Reserve Board, in considering the necessity for a more specific description of the type of activity which would constitute "arranger of credit," inquired whether real estate brokers who arrange seller financing of homes should be considered “arrangers of credit.” In 1982, Congress resolved the question by passing the Garn-St. Germain Depository Institutions Act, which amended the Truth in Lending Simplification and Reform Act of 1980 by deleting “arranger of credit” from the definition of ‘‘creditor.” To implement the amendment, the Federal Reserve Board amended revised Regulation Z by removing “arranger of credit” from the “creditor” definition, effective October 1, 1982. The effect of the Board’s action is to release real estate brokers or other arrangers of credit from the responsibility for providing Truth in Lending disclosures unless such persons otherwise come within the definition of “creditor.”

Exempt Transactions

There are two basic types of transactions that are exempt from coverage under Regulation Z. The first exemption is for credit extended primarily for a business, commercial, or agricultural purpose. If property is not, or is not intended to be, owner-occupied, and the creditor extends credit to acquire, improve, or maintain a rental property, regardless of the number of family units, the transaction will be considered to be for a business purpose.

Special rules apply for credit to acquire, improve, or maintain rental property that is, or will be, owner-occupied within a year. If the property contains more than two family units and the purpose of the credit is to acquire the property, the credit is deemed to be for a business purpose. However, if the credit is extended to improve or maintain the property, it is deemed to be for a business purpose if it contains more than four housing units. These rules should not be construed to prevent an extension of credit for property containing fewer than the aforesaid prescribed number of units from being considered business credit. Credit involving fewer numbers of units may be considered business credit depending on the circumstances of the transaction.

The second exemption is for credit over $25,000. The dollar limitation does not apply if the loan is secured by real property, or by personal property which is used or expected to be used as the consumer’s principal dwelling.

See Section 226.3 of Regulation Z, 12 C.F.R. § 226.3.

Form of Disclosures

Regulation Z requires all Truth in Lending disclosures concerning the credit sale or loan to be grouped together and segregated from other information. The Regulation prohibits the inclusion of any information not directly related to the disclosures required by Regulation Z. It also provides that any itemization of the amount financed be made separately from the other required disclosures. In addition, Regulation Z requires that the terms “finance charge” and “annual percentage rate” be more conspicuous than other required disclosures.

The disclosures may be segregated by putting them on a separate sheet of paper, or if the disclosures are on a contract or other document they may be set off from other information by outlining them in a box or by printing them in a different type style, with bold print dividing lines, or with a different color background. The portion of the sale or loan document that contains these disclosures is commonly called “the federal box.”

Before its revision, Regulation Z required that all Truth in Lending disclosures be made on one side of a page. Under revised Regulation Z, the Truth in Lending disclosures must be separate from everything else, but may be continued from one page to another.

Regulation Z contains several model forms, including forms which contain disclosures required for transactions involving loan assumptions, variable rate mortgages, and graduated payment mortgages. Lenders may duplicate these forms or modify them by including disclosures required for particular transactions.

See Section 226.17 of Regulation Z.

Required Disclosures

There are as many as eighteen disclosures required by Regulation Z for closed-end credit transactions such as mortgage loans. A creditor is only required to make those disclosures that are relevant to a particular transaction. The disclosure statement must have simple descriptive phrases next to five of the most important items disclosed. These items are: the amount financed, the finance charge, the annual percentage rate, the total of payments, and, in credit sales, the total sale price. Regulation Z provides suggested phrases for the five required terms. These phrases are not required to be used verbatim.

The following is a summary of the required disclosures:

Identity of creditor. The creditor making the disclosures must be identified.

Amount financed. Regulation Z requires the use of the term “amount financed” together with a brief description of the term. The suggested phrase is “the amount of credit provided to you or on your behalf.”

Itemization of amount financed. The disclosure of the itemization of the amount financed may be eliminated in those cases where good faith estimates of settlement costs have been supplied for transactions subject to the Real Estate Settlement Procedures Act (RESPA). If the transaction is not subject to RESPA, the creditor must either provide a written itemization of the amount financed, or provide a statement that the consumer has the right to receive a written itemization of the amount financed together with a space for the consumer to indicate whether an itemization is desired. However, many state laws require that the creditor provide the itemization even if the consumer does not specifically request it. The itemization must be separate from the “federal box.”

Finance charge. Regulation Z requires the use of the term “finance charge” together with a brief description such as “the dollar amount the credit will cost you.”

The requirement that the components of the finance charge be itemized has been eliminated from revised Regulation Z. In fact, the new rules prohibit creditors from itemizing the finance charge with the other disclosures. Only the total amount may be given. In addition, Regulation Z requires the disclosure of the finance charge in all real estate transactions. Prior to its revision, Regulation Z did not require either the total dollar amount of the finance charge or the total of payments to be disclosed on a first loan to finance the purchase of the borrower’s dwelling.

The finance charge must include any charge payable directly or indirectly by the consumer and imposed directly or indirectly by the creditor as incident to or a condition of the extension of credit. Regulation Z provides examples of charges that must be included in the finance charge and examples of charges that are excluded from the finance charge.

Charges of particular importance in real estate and residential mortgage transactions which Regulation Z lists among those charges included in the finance charge are:

1. interest;
2. loan fees, assumption fees, finder’s fees and buyer’s points;

3. investigation and credit report fees;
4. premiums for mortgage guaranty or similar insurance; and
5. borrower-paid mortgage broker fees.

Charges which are not finance charges include seller's points and the following fees when charged in a transaction secured by real property or in a residential mortgage transaction (which may include the purchase of a mobilehome), if they are bona fide and reasonable in amount:

1. fees for title examination, abstract of title, title insurance, property survey, and similar purposes;
2. fees for preparing loan-related documents;
3. notary, appraisal, credit report, and pest infestation and flood hazard inspection fees;
4. amounts required to be paid into escrow or trustee accounts if the amounts would not otherwise be included in the finance charge; and
5. third-party closing agent fees (including those charged by settlement agents, attorneys, and escrow and title companies).

Annual percentage rate. The disclosure of the annual percentage rate requires the use of that particular term together with a brief description such as "the cost of your credit as a yearly rate." In a regular transaction, the disclosed annual percentage rate is considered accurate if it is not more than 1/8 of 1 percentage point above or below the actual annual percentage rate determined. However, in an irregular transaction, the annual percentage rate is considered accurate if it is not more than l/4 of 1 percentage point above or below the actual annual percentage rate determined. Irregular transactions include multiple advances, irregular payment periods (other than an odd first period), or irregular payment amounts (other than an odd first or final payment).

Variable rate. If the annual percentage rate may increase within a term of one year or less after consummation in a transaction secured by the consumer's principal dwelling, there must be disclosure of:

1. the circumstances under which the rate may increase;
2. any limitations on the increase;
3. the effect of an increase; and
4. an example of the payment terms that would result from an increase.

If the annual percentage rate may increase within a term greater than one year after consummation in a transaction secured by the consumer's principal dwelling, there must be disclosure of:

1. the fact that the transaction contains a variable-rate feature; and
2. a statement that variable-rate disclosures have been provided earlier.

Payment schedule. The creditor must disclose the number, amounts, and timing of payments scheduled to repay the obligation. Regulation Z provides for an abbreviated disclosure of payment schedule for transactions in which a series of payments vary solely because of the application of a finance charge to the unpaid principal balance. This situation arises most frequently in graduated payment mortgages or in mortgages where mortgage insurance premiums are based on the unpaid principal balance. In these transactions creditors need to disclose only the amount of the largest and smallest payments in the series and that the other payments may vary.

Total of payments. Regulation Z requires the creditor to use the term “total of payments” as well as a brief description such as “the amount you will have paid when you have made all scheduled payments.” The total of payments (which is the sum of the payments disclosed in the payment schedule) must be disclosed for all real estate transactions under revised Regulation Z.

Demand feature. Regulation Z requires that if the obligation has a demand feature, that fact be disclosed. This disclosure is required only for a demand feature contemplated by the parties as part of the legal obligation. Transactions that convert to a demand status as a result of the consumer’s default are not within the purview of this requirement. Nor is a due-on-sale clause.

Total sale price. In a credit sale (a sale in which the seller is a creditor) Regulation Z requires the use of the term “total sale price” together with a brief description such as “the total price of your purchase on credit, including your down payment of $___.”

Prepayment penalties and rebates. Creditors are required to make a disclosure of the existence of a penalty on prepayment in full. Even if a creditor does not charge a prepayment penalty, a statement to that effect must be included. However, this disclosure is only required if the finance charge is computed from time to time by application of a rate to the unpaid principal balance. In any other type of transaction, a statement must be included indicating whether the consumer is entitled to a rebate of any portion of the finance charge in the event of prepayment. It is no longer necessary to disclose a particular method of rebate, such as the rule of 78s.

Late payment charge. A disclosure is required only for those charges imposed before maturity due to a late payment. The disclosure may reflect the fact that late charges may be determined as either a percentage or a specified dollar amount.

Security interest. Regulation Z requires the creditor to disclose what security interest is or will be retained in the property purchased in the transaction or other property. In transactions in which the credit is being used to purchase the collateral, the creditor is required to give only a general identification such as “the property purchased in this transaction.” In the revision of Regulation Z, the requirement that a security interest in after-acquired property must be disclosed was deleted.

Insurance. If charges for credit life, accident, health, or loss-of-income insurance are excluded from the finance charge, there must be a disclosure of the premium and that the insurance is not required to obtain credit, and the consumer must sign or initial a request for the insurance. If the charges for property insurance are excluded from the finance charge there must be a disclosure setting forth the cost of the insurance if obtained from the creditor and stating that the insurance may be obtained from a person of the consumer’s choice. The disclosure may be made on the disclosure form, or, at the creditor’s option, on a document different from the disclosure form.

Certain security charges. If disclosed, taxes and fees paid to a public official with respect to a security interest may be excluded from the finance charge. The charges may be aggregated, or may be broken down by individual charge. No special form is required for this disclosure, which could be labeled “filing fees and taxes.” This disclosure may be made on the disclosure form, or, at the creditor's option, on a document different from the disclosure form.

Reference to contract terms. Regulation Z requires that creditors include in their disclosures a statement that refers consumers to appropriate contract documents for information about non-payment, default, the right to accelerate the maturity of the obligation, and prepayment rebates or penalties. At the creditor's option, the statement can also include a reference to the contract for more information about security interests and the creditor's assumption policy.

Assumption policy. In a residential mortgage transaction, the creditor must state whether a subsequent purchaser of the dwelling from the consumer may be permitted to assume the remaining obligation on its original terms.

Required deposit. An example of a required deposit is a savings account created as a condition of a loan. If a creditor requires the consumer to maintain the deposit as a condition of the extension of credit, the creditor must state that the annual percentage rate does not reflect the effect of the required deposit.

See Section 226.18 of Regulation Z.

Time of Disclosure

Regulation Z requires disclosures to be made before consummation of the credit transaction, which is usually the time of closing. Consummation is defined as the time that a consumer becomes contractually liable on a credit obligation as determined by state law. In some situations, special variable rate and other disclosures (discussed below) must be provided at an earlier point in time.

Certain residential mortgage transactions. Creditors, as a whole, have been encouraged, through liberalized provisions on estimates in the revised Regulation Z, to use early disclosures in order to enable consumers to have ample time to shop for credit. However, creditors involved in residential mortgage transactions subject to the Real Estate Settlement Procedures Act, known as RESPA, are required to make Regulation Z disclosures before consummation, or deliver or place them in the mail within three business days after receiving the consumer's written application, whichever is earlier. If the estimates turn out to be inaccurate, it may be necessary to make another disclosure at consummation.

See Sections 226.17(b), 226.17(f), and 226.19(a) of Regulation Z.

Certain variable-rate transactions. If the annual percentage rate may increase after consummation in a transaction secured by the consumer's principal dwelling with a term greater than one year, the following disclosures must be provided at the time an application form is provided or before the consumer pays a nonrefundable fee, whichever is earlier:

1. the booklet titled *Consumer Handbook on Adjustable Rate Mortgages* published by the Board and the Federal Home Loan Bank Board, or a suitable substitute; and
2. a loan program disclosure for each variable-rate program in which the consumer expresses an interest.

Redisclosure. In general, an event occurring after delivery of the disclosures to the consumer, which renders the disclosures inaccurate, does not result in a violation of Regulation Z and does not require redisclosure. However, if disclosures are given before the date of consummation and a subsequent event makes them inaccurate prior to consummation, redisclosure is required before consummation, if the actual annual percentage rate is above or below the disclosed rate by more than l/8 of 1 percent in a regular transaction, or more than 1/4 of 1 percent in an irregular transaction, as described above.

If redisclosure is required, the creditor has the option of providing the consumer with either a complete set of new disclosures or a disclosure of *only* the terms that vary from those originally disclosed.

Subsequent Disclosure

After consummation, three events require the creditor to make disclosures: refinancing, assumption, and variable-rate adjustments.

Refinancing. Regulation Z states that a "refinancing" is a new transaction requiring new disclosures to the consumer, and that a refinancing occurs when an existing obligation is satisfied and replaced by a new one undertaken by the same consumer. In addition, the Regulation sets forth examples of what does not constitute a refinancing, which include, among others: (l) a renewal of a single payment obligation with no change in the original terms; (2) a reduction in the annual percentage rate with a corresponding change in the payment schedule; and (3) a change in the payment schedule or a change in collateral requirements as a result of the consumer's default or delinquency.

Assumption. Regulation Z states that an "assumption" is a new transaction requiring new disclosures to the consumer, and that an assumption occurs when a new party becomes obligated on an existing obligation. Whenever a creditor agrees in writing to accept a new consumer as a primary obligor on an existing residential mortgage transaction, before the assumption occurs the creditor must make new disclosures to the new obligor based on the remaining obligation. The mere addition of a guarantor to an obligation for which the original consumer remains primarily liable does not constitute an "assumption."

See Sections 226.17(e), 226.19 and 226.20 of Regulation Z.

Variable-rate adjustments. Certain new disclosures are required when an adjustment is made to the interest rate (with or without an accompanying change in the payment rate) in a variable rate transaction secured by the consumer's principal dwelling and with a term greater than one year. The creditor must provide the following information at least once each year during which an interest rate adjustment is implemented without an accompanying payment change, and at least 25 but not more than 120 calendar days before a payment is due at a new level:

1. the current and prior interest rates;
2. the index values on which the current and prior interest rates are based;
3. the extent to which the creditor has foregone any interest rate increase;
4. the contractual effects of the adjustment, including the new payment amount and the loan balance; and
5. the payment (if different from the payment disclosed above) that would be required to fully amortize the loan at the new interest rate over the remaining loan term.

Additional Disclosures Required for High-Rate, High-Fee Mortgages

The "Home Ownership Equity Protection Act of 1994" amended the Truth in Lending Act to establish new requirements for certain loans with high rates and/or high fees. The requirements do not apply to loans to purchase or initially construct a consumer's principal dwelling, to reverse mortgages, or to home equity lines of credit. Loans are covered if they meet the following tests: (1) the annual percentage rate exceeds by more than 10 percentage points the rate on Treasury notes of comparable maturity; or (2) the total fees and points exceed the larger of 8 percent of the total loan amount or $424 (for 1997 - dollar amount adjusted annually by the Federal Reserve Board, based on changes in the Consumer Price Index). The amendments primarily affect refinancing and home equity installment loans that also meet the definition of a high-rate or high-fee loan.

In addition to the other Truth in Lending Act disclosures described above, high-rate or high-fee loans, also referred to as "Section 32 mortgages," must include the following disclosures:

1. a written notice stating that the loan need not be completed, even though the consumer has signed the loan application and received the required disclosures;
2. a warning that failure to make required payments could result in the consumer losing the home;
3. disclosure of the APR and regular payment amount; and
4. in the case of variable rate transactions, a statement that the interest rate and monthly payment may increase, as well as the amount of the single maximum monthly payment (based on the maximum interest rate).

The consumer has three business days to sign the loan agreement after receiving the Section 32 disclosures.

The 1994 amendments also ban the following features from high-rate, high-fee loans:

1. all balloon payments for loans with less than five-year terms (with an exception for bridge loans of less than one year used by consumers to acquire or construct a home);
2. negative amortization;
3. default interest rates higher than predefault rates;
4. rebates of interest upon default calculated by any method less favorable than the actuarial method;
5. a prepayment schedule that consolidates more than two periodic payments that are to be paid in advance from the proceeds of the loan; and
6. most prepayment penalties, including refunds of unearned interest calculated by any method less favorable than the actuarial method.

Creditors also are prohibited from engaging in a pattern or practice of lending based on the collateral value of property without regard to the consumer's ability to repay the loan. In addition, proceeds for home improvement loans must be disbursed either directly to the consumer, jointly to the consumer and home improvement contractor, or, in some instances, to the escrow agent.

See Section 226.32 of Regulation Z.

Consumer's Right to Rescind

As a general rule, the right of rescission applies to all consumer credit transactions where the obligation is secured by a lien against the consumer's principal dwelling. A consumer can have only one "principal dwelling" at a time. Since the definition of a dwelling is not limited to real property, transactions involving mobilehomes can be rescindable even if they are treated as personal property under state law.

Exemptions. There are a number of important exemptions applicable to residential real estate transactions. One of these exemptions concerns "residential mortgage transactions." Under this exemption, the right of rescission does not apply to transactions made to finance acquisition or initial construction of the consumer's principal dwelling and secured by that dwelling, regardless of lien status. In other words, second mortgages for the purpose of financing an acquisition are no longer subject to the right of rescission.

Another exemption is for a refinancing by the same creditor of a loan already secured by the principal dwelling, provided no new money is advanced. If new money is advanced, the transaction is rescindable to the extent of the new money if the loan is secured by the consumer's principal dwelling. This exemption is most likely to arise in connection with renewals, extensions, or refinancing of balloon notes.

By restricting the right of rescission to transactions in which the secured property is currently used as the consumer's principal dwelling, revised Regulation Z has exempted from the rescission requirements loans secured by property that is expected to be used as other than a principal dwelling, such as vacant lots, vacation homes, and retirement homes.

Notice of right to rescind. The creditor must provide each consumer entitled to rescind (any consumer with an "ownership interest" in the principal dwelling subject to the security interest) with two copies of the notice of right to rescind. Creditors are not required to use any specific language when making rescission disclosures. Regulation Z contains a model rescission form that meets the requirements.

Rescission period. The consumer has the right to rescind until midnight of the third business day following the last to occur of these events:

1. consummation of the transaction;
2. delivery of all material Truth in Lending disclosures; or
3. delivery of the notice of right to rescind. A business day is any calendar day, except Sundays and federal legal holidays.

Waiver of right to rescind. Regulation Z provides that the consumer may waive the right to rescind if the consumer determines that the extension of credit is needed to meet a bona fide personal financial emergency. To waive the right, the consumer must give the creditor a dated written statement that describes the emergency and specifically waives the right to rescind. The use of preprinted waiver forms is prohibited by the Regulation.

See Section 226.23 of Regulation Z. (A parallel provision exists in Section 226.15 of Regulation Z for liens against principal dwellings securing open-end credit.)

Advertising Consumer Credit

Anyone placing an advertisement for consumer credit must comply with the advertising requirements of the Truth in Lending Act and Regulation Z. Thus, real estate brokers and home builders who place ads must comply even if they are not creditors in the financing being advertised.

Disclosures in credit advertisements must be made "clearly and conspicuously." This standard requires that disclosures be made in a reasonably understandable form, but does not prescribe the type size or the placement of disclosures in the ad.

An advertisement may state specific credit terms only if the creditor is actually prepared to offer those terms. A creditor may advertise terms that will be offered for only a limited period, or terms that will become available at a future date.

Advertising the rate of finance charge. If the finance charge in a credit advertisement is expressed as a rate, it must be stated as an "annual percentage rate," using that term or the abbreviation "APR." If a component of that finance charge is interest computed at a simple annual rate, that rate *may* also be included. However, it must not be displayed more conspicuously than the annual percentage rate. For example, an advertisement for mortgage credit may include the contract rate of interest together with the annual percentage rate, which reflects insurance, discounts, points, and other charges, as well as interest.

Variable rate mortgages. If the annual percentage rate offered may be increased after consummation of the transaction, the advertisement must state that fact. An advertisement for a variable rate mortgage with an initial annual percentage rate of 9% that may vary after settlement without any limit could be advertised as "9% annual percentage rate, subject to increase after settlement." This disclosure may be used for any type of mortgage instrument with a variable interest rate. It may not be used in advertisements of graduated payment mortgages that have a fixed interest rate and payments that may increase during the loan. Fixed-rate "buydowns" and "step-rate" mortgages are also *not* variable rate mortgages. These mortgages involve different interest rates in effect during the life of the loan, all of which are known at settlement. A variable rate transaction involves future interest rates unknown at settlement.

The Official Staff Commentary to Regulation Z, which is published by the staff of the Federal Reserve Board, sets forth special rules for advertising rates other than simple annual or periodic rates, i.e., for "buydowns" and "payment" or "effective" rates.

Buydowns. A seller or creditor may advertise a reduced simple interest rate resulting from a "buydown" so long as the advertisement shows the limited term to which the reduced rate applies and the simple interest rate that applies to the balance of the term, as well as the annual percentage rate that is determined in accordance with the commentary to Section 226.17(c) of Regulation Z. (Where more than one reduced rate applies, the advertisement must show each rate and the respective term for which each rate is effective.) The advertisement may also show the effect of the buydown on the payment schedule without triggering additional disclosures under Section 226.24(c) of Regulation Z.

Discounted variable rates. Adjustable rate mortgages (ARMs) often have a first-year "discount" or "teaser" feature in which the initial rate is substantially reduced. In these loans, the first year's rate is not computed in the same way as the rate for later years. Often the "spread" or "margin" that is normally added to an "index" (such as the one-year Treasury-note rate) to determine changes in the interest rate in the future is not included in the first year of a discounted ARM offered by a creditor. Special rules, similar to those for buydowns, apply to advertising a discounted variable rate. An advertisement for this type of plan can show the simple interest rate during the discount period, as long as it also shows the annual percentage rate. However, in contrast to buydowns, the ad need not show the simple interest rate applicable after the discount period. For example, a plan with a low first year's interest rate (8%), but with a 10.25% rate in subsequent years, and additional credit costs, could be advertised as follows: "8% first-year financing. APR 10.41%. APR subject to increase after closing." As in buydowns, the annual percentage rate in discounted plans is a composite figure that must take into account the interest rates that are known at closing. In the above example, the disclosed APR must reflect the 8% rate for the first year, as well as, for example, the 10.25% rate applicable for the remainder of the term, plus any additional credit costs (such as buyer's points). An ad for a discounted variable-rate loan, like an ad for a buydown, may show the effect of the discount on the payment schedule during the discount period *without* triggering other disclosures. An example of a disclosure that complies with Regulation Z is: "Interest rate only 8% first year. APR 10.50% subject to increase. With this discount, your monthly payments for the first year will be only $587."

Payment or effective rates. In some transactions, particularly some graduated payment loans, the consumer's payments for the first few years of the loan may be based upon an interest rate lower than the rate for which the consumer is liable (a situation referred to as "negative amortization"). As with buydowns, special rules apply when the "effective" or "payment" rates are advertised for such transactions. The following information must be included in any advertisements containing effective rates: (1) the "effective" or "payment" rate; (2) the term of the reduced payments; (3) the "note rate" at which interest is actually accruing; and (4) the annual percentage rate. The advertised annual percentage rate must take into account the interest for which the consumer is liable, even though it is not paid by the consumer during the period of reduced payments. This type of financing could be advertised as: "An effective first-year rate of only 7-1/2 percent. Interest being charged at 10-1/2 percent. 10-3/4% APR." In contrast to an ad for a buydown or a discounted variable rate, an ad for an "effective" or "payment" rate may *not* show the monthly payments without triggering the disclosures listed in the following section.

Advertising terms that require additional disclosures. If only the annual percentage rate is disclosed, additional disclosures are not required. If, however, an advertisement contains any one of the following terms, the ad must also disclose other credit terms:

1. the amount or percentage of any downpayment;
2. the number of payments or period of repayment;
3. the amount of any payment; or
4. the amount of any finance charge.

These provisions apply even if the so-called "triggering term" is not stated explicitly but may be readily determined from the advertisement. An ad that states "80% financing" implies that a 20 percent down payment is required. However, an ad that states "100% financing" requires no further disclosures because no downpayment is required.

If any triggering term is used, then the following three disclosures must also be included in the advertisement:

1. the amount or percentage of the down payment;
2. the terms of repayment; and
3. the "annual percentage rate," using that term or the abbreviation "APR." If the annual percentage rate may be increased after consummation of the credit transaction, that fact must be disclosed.

Regulation Z also permits the advertiser to substitute examples of one or more typical extensions of credit for required disclosures that are specific to a particular transaction. Where typical examples are used, the advertisement must contain all of the terms that apply to each example. The examples must be typical of the credit terms that are actually available.

See Section 226.24 of Regulation Z.

The Official Staff Commentary to Regulation Z provides additional guidance and illustrative examples of these general rules. It also prescribes special rules for advertising complex transactions such as graduated payment mortgages and wrap-around loans.

In addition, the Federal Trade Commission publishes a manual for business entitled "How to Advertise Consumer Credit: Complying with the Law." This manual is available from the U.S. Government Printing Office.

Administrative Enforcement

The Federal Trade Commission enforces the Truth in Lending Act and Regulation Z with respect to real estate brokers, mortgage loan brokers, mortgage bankers, and other creditors and advertisers not regulated by the following federal agencies, which have jurisdiction over the indicated financial institutions:

Comptroller of the Currency (national banks);

Federal Deposit Insurance Corporation (FDIC - insured banks that are not members of the Federal Reserve System);

Federal Reserve Board (state member banks of the Federal Reserve System),

Office of Thrift Supervision (Federally-insured savings institutions and members of the Office of Thrift Supervision System not insured by FDIC); and

National Credit Union Administration (federally chartered credit unions).

The FTC may determine that a creditor or advertiser has violated the law and order the creditor or advertiser to cease and desist from further violations. Violations of such an administrative order may result in an $11,000 civil penalty each day the violation continues.

If creditors or advertisers engage in practices which they know the Commission has previously determined to be unfair or deceptive, the Commission may file an action in federal district court seeking penalties of up to $11,000 for each violation.

In addition, where a creditor inaccurately discloses an annual percentage rate or finance charge, the FTC can require the creditor to adjust the accounts of persons to whom credit was extended to assure that the obligors will not be required to pay a finance charge in excess of the finance charge actually disclosed or the dollar equivalent of the disclosed annual percentage rate, whichever is lower. Section 108(e) of the Truth in

Lending Act sets forth the conditions under which these administrative restitution cases may be brought, as well as defenses the creditor can assert in such cases.

Civil Liability

Under the amended Truth in Lending Act, a creditor may be liable to a consumer for a statutory penalty of twice the amount of the finance charge, with a minimum of $100 and a maximum of $1,000. Statutory liability applies only to seven specific violations: Failing to properly disclose the right of rescission, where applicable; and the improper disclosure of the amount financed, the finance charge, the annual percentage rate, the total of payments, the payment schedule, or the security interest taken by the creditor. In addition, the creditor is liable for actual damages suffered by the consumer and, if the consumer prevails, for the consumer's reasonable attorney's fees and costs. The creditor can avoid such liability if it notifies the consumer within 60 days after discovering the error and adjusts the account to reflect the correct annual percentage rate or finance charge, provided the consumer has not instituted suit, or the creditor has not received written notice of its error, prior to its notification.

Creditors are not liable for violations that were unintentional and resulted from bona fide errors. They must show that they have procedures reasonably adapted to prevent such errors. Examples of bona fide errors include clerical, calculation, computer malfunction and programming, and printing errors. Errors of legal judgment do not qualify as bona fide errors.

Creditors are deemed to be in compliance with the nonnumerical disclosure provisions of the Truth in Lending Act if the creditor: (l) uses any appropriate model form or clause as published by the Federal Reserve Board; or (2) uses any such model form or clause and changes it by (a) deleting any information that is not required by the Act, or (b) rearranging the format, if in making such deletion or in rearranging the format, the creditor does not affect the substance, clarity, or meaningful sequence of the disclosure.

See Sections 105(b) and 130 of the Truth in Lending Act.

Criminal Liability

A creditor is also subject to a fine of not more than $5,000 or imprisonment for not more than one year, or both, for willfully and knowingly violating the Act or Regulation Z by giving false or inaccurate information, failing to provide required disclosures, or consistently understating the annual percentage rate.

See Section 112 of the Truth in Lending Act.

Conclusion

The foregoing summary of the Truth in Lending Act and Regulation Z incorporates the Federal Reserve Board's official staff commentary issued in October, 1981, and the updates to the commentary through March, 1996. The summary is intended to be a guide to the new law; it does not cover all contingencies. Anyone needing additional information may contact the Federal Trade Commission, 11000 Wilshire Blvd., Suite 13209, Los Angeles, California 90024. Telephone number: (310) 235-4040.