



Truth-In-Lending APR Calculation Best Practices to Assure Regulation Z Compliance

THOUGHT LEADERSHIP

Thought Leadership

ACCURACY MATTERS when it comes to Regulation Z Annual Percentage Rate Calculations

Carleton regularly receives client inquiries regarding how best to achieve accuracy in Truth-in-Lending (“TILA”) disclosures for retail installment contracts.

To address the corresponding regulatory requirements, there are three key considerations:

- ✓ TILA’s Regulation Z states the annual percentage rate is “to be determined,” i.e. calculated
- ✓ Appendix J to Regulation Z contains 15 pages of definitions, variables, and algorithms to accurately calculate an APR value
- ✓ Yet, nowhere within Regulation Z is there any guidance that “in the absence of fees included in the finance charge, the resulting APR will be the same as the interest rate”

Common Practices vs Best Practices

It is a common practice of Loan Origination and Dealer Management Systems to pass the contract interest rate to populate the TILA APR portion of the “Fed Box” for retail installment sales transactions. In those instances, there is no actual ‘calculation’ of an APR but it is simply a reiteration of the interest rate.

The frequent assumption is that with no fees included as part of the TILA finance charge, the interest rate will always be within the 0.125% tolerance allowed by Regulation Z when measured from an accurately-calculated TILA APR.

However, to assure compliance—despite the interest rate value being within the tolerance most of the time—**Carleton’s recommendation is to always compute an accurate and precise APR** to absolutely ensure compliance for both regulatory and civil liability needs.

Reg. Z - § 1026.22 Determination of annual percentage rate.

“The annual percentage rate is a measure of the cost of credit, expressed as a yearly rate...”

Creditors may use any other computation tool in determining the annual percentage rate if the rate so determined equals the rate determined in accordance with appendix J to this part, within the degree of accuracy set forth in paragraph (a) of this section.”

The Compliant APR Calculations Challenge

Very often the two resulting rates (the APR and the interest rate) may legitimately be represented by identical values. More often than not, any differences are driven by differences in the calendars used by the system(s) to compute the actual interest.

In today's world, "simple interest" has become quite prevalent and incorporates an interest charge based on the actual calendar days existing between scheduled payments. **But the actuarial method of computing a TILA APR disregards** the fact that months have varying numbers of days and treats each "month" as 1/12 of a year. Thus, the two rates in comparison may actually be derived from disparate and divergent principles.

It is important to note that the 0.125% tolerance requirement is only a TILA "regulatory safe harbor" within a lending transaction. The more critical concern is often litigation and defending an ongoing "pattern of practice." Should an accurately-computed APR be slightly larger than a base-computed interest rate on a regular basis, a claim of consistently under-stating the APR value on the contract to consumers may be problematic.

A Prudent Approach & Course of Action

The chosen methodology is ultimately driven by a lender's tolerance for risk pertaining to compliance.

Carleton's best practice recommendation is for lenders to adopt an accurately-computed TILA APR as their "no-risk" solution.



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