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Clarification of Interim Rule Relating to the Mortgage Disclosure Improvement Act

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BRIEF SUMMARY

On December 22, 2010, the Federal Reserve Board (“Board”) issued a clarification of its original interim rule to implement certain disclosure provisions of the Mortgage Disclosure Improvement Act of 2008 (“MDIA”). The original interim rule requires the disclosure of a rate and payment summary table for closed-end loans secured by real property or a dwelling. Compliance with the original interim rule is mandatory on January 30, 2011. The Board’s clarifications, published in the form of a new interim rule, will be effective on January 30, 2011 as well, but compliance is optional until October 1, 2011. This Client Alert summarizes the Board’s clarifications and explains how creditors must implement them.

HISTORY AND SCOPE

- The Board’s original interim rule was issued under the MDIA as an amendment to Regulation Z. See 75 Fed. Reg. 58470 (September 24, 2010). The original interim rule applies to closed-end credit transactions secured by real property or a dwelling, but excludes loans secured by consumers’ interests in certain timeshare plans. The original interim rule became effective on October 25, 2010 but compliance is optional until January 30, 2011. Compliance is mandatory for applications received on or after that date.
- Under the original interim rule, the Board issued a new Section 226.18(s) of Regulation Z as well as related provisions of the Official Staff Commentary to Regulation Z (“Commentary”). Section 226.18(s) requires an interest rate and payment summary table rather than an exact payment schedule reflecting every payment due for every phase of the loan. A Client Alert summarizing the original interim rule is at <http://www.mofo.com/files/Uploads/Images/100820InterimRule.pdf>.
- The new interim rule issued by the Board on December 22, 2010 clarifies some issues that have arisen with respect to the original interim rule. Comments on the new interim rule must be received within 60 days following its publication in the Federal Register.
- The new interim rule is effective on January 30, 2011. However, compliance with the new interim rule is optional with respect to transactions for which a credit application is received by the creditor through September 30, 2011. Compliance is mandatory with respect to all credit transactions for which a credit application is received by the creditor on or after October 1, 2011.
- The Board will issue a permanent rule on the MDIA disclosures at some point. The new interim rule does not address all issues that were the subject of comment for the original interim rule. Comments received with respect to both the original interim rule as well as the new interim rule can be taken into consideration when the permanent rule is issued.

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HIGHLIGHTS OF THE NEW INTERIM RULE AND ANALYSIS

- **Calculation of Total of Payments for Closed-End Loans Secured by Real Property or a Dwelling (Paragraph 226.18(h)-2 of the Commentary)**
 - For all closed-end loans secured by real property or a dwelling, the Total of Payments in the Regulation Z disclosure statement will be calculated in the same manner as for other closed-end loans. That is, the Total of Payments for these loans will be calculated as if the loans were still subject to § 226.18(g) of Regulation Z, the existing rule for closed-end loans that requires a precise disclosure of the number, amounts, and timing of all payments necessary to repay the loan.
 - In calculating the Total of Payments, the creditor must use all of the rules in § 226.18(g) and the corresponding Commentary provisions. For adjustable rate mortgages (“ARMs”), the creditor must adhere to the rules in Paragraphs 226.17(c)(1)-8 and -10 of the Commentary. Among other things, these rules instruct how creditors should take introductory interest rates into consideration when making disclosures.
 - In short, creditors making loans secured by real property or a dwelling must retain their existing capability for determining the Regulation Z payment schedule under § 226.18(g) in order to calculate the Total of Payments correctly.
- **Maximum Rate for First Five Years of Loan (Section 226.18(s)(2)(i)(B)(2) of Regulation Z)**
 - The original interim rule required a disclosure of the maximum interest rate that may apply for the first five years after the consummation of the loan.
 - The new interim rule requires a disclosure of the maximum interest rate that may apply for the first five years after the first regular periodic payment that will be due on the loan.
 - This change was squarely directed at 5/1 ARMs. Under the original interim rule, the first rate change for a 5/1 ARM would not have been disclosed in the “maximum during first five years” column because it would not occur within five years from the consummation of the loan. Under the new interim rule, the first rate change for a 5/1 ARM must be disclosed in the “maximum during first five years” column.
 - Example: A 5/1 ARM is consummated on August 16, 2011. The first payment is due on October 1, 2011. The first rate adjustment will occur on September 1, 2016. Under the new interim rule, the “maximum during first five years” column must disclose this interest rate adjustment as well as the corresponding loan payment.
- **Alteration of Model Clauses for Loans that are Payable Other than Monthly (Paragraph 226.18(s)-1 of the Commentary)**
 - Because most mortgage loans require regular monthly payments, the original interim rule and many of its model clauses reference monthly payments.
 - For loans whose periodic payments are not made on a monthly basis, the new interim rule clarifies that the creditor should use the appropriate description of the payment intervals, such as “bi-weekly” or “quarterly.”

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- Example: Model Clause H-4(F) provides an interest rate and payment table for an ARM or step-rate mortgage. The first column of this table is entitled “Introductory Rate & Monthly Payment” and the last row of this table is entitled “Total Est. Monthly Payment.” If a creditor’s ARM provides for quarterly payments, then the first column of the table will be entitled “Introductory Rate & Quarterly Payment” and the last row of this table will be entitled “Total Est. Quarterly Payment.”
- **Disclosure of Additional Column for Interest-Only Loans (Section 226.18(s)(3)(ii)(B) of Regulation Z and Paragraph 226.18(s)(2)(i)(C)-1 of the Commentary)**
 - The original interim rule states that where a loan provides for a payment increase that does not coincide with an interest rate adjustment, the interest rate and payment table must include an additional column that shows the increased payment, the earliest date that the payment increase can occur, and the interest rate in effect at the time of the increase.
 - The new interim rule clarifies that, for an interest-only loan, it is necessary to show this additional column when the borrower is first required to make principal and interest payments. This column must be shown even if the interest rate is not being adjusted at that time. The column’s itemization of the amounts payable to principal and interest should show the first such payment.
 - Example: If an ARM has an initial fixed interest rate for five years, and the payments for the first three years are interest-only, the following columns will be required: the introductory interest rate and payment (with the payment itemized to show that the entire payment amount is applied to interest and \$0 is applied to principal); the principal and interest payment that applies once the interest-only period ends; the maximum interest rate and payment for the first five years of the loan (i.e., the maximum rate once the initial five year rate expires); and the maximum interest rate and payment for the entire loan term.
 - The Commentary further clarifies that an additional column is not required by the rule described above solely due to the fact that some months have different numbers of days.
 - The new interim rule also clarifies that, for an interest-only loan, when the column showing the first payment of principal and interest is required, the column should show the interest rate in effect at the time of the payment increase and the earliest date that the interest rate was effective. In a change from the original interim rule, the date that the increased payment will first be due must not be shown.
- **Disclosure of Escrows for Taxes and Insurance for Amortizing Loans (Including Interest-Only Loans) (Section 226.18(s)(3)(i)(C) of Regulation Z and Paragraph 226.18(s)(3)(i)(C)-1 of the Commentary)**
 - The original interim rule states that the interest rate and payment table needs to disclose that an escrow account is required, if this is the case, and the estimated amount of any taxes and insurance (including any mortgage insurance) that are included in each month’s payment.
 - The new interim rule makes clear that the escrow payment must be disclosed regardless of whether the escrows are mandatory or voluntary. Also, the new rule eliminates the provision mandating a statement that the escrow account is required (where this is the case).

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- The escrow amount may, but need not, include items other than taxes and insurance, such as homeowner's association dues. Premiums for credit insurance, debt suspension and cancellation agreements, and similar items may not be included in the escrow amount.
- In general, the escrow amount shown in each column must be the same. However, the estimate must reflect changes in the mortgage insurance premiums that are known to the creditor at the time that the disclosure is made. For example, where mortgage insurance premiums are calculated on a declining principal balance, a reduction in the premiums caused by the amortization of the loan (at the rates assumed for purposes of the disclosure of those rates in the various columns) should be reflected in the columns. Also, as noted in the original interim rule, the creditor must assume that mortgage insurance premiums will continue to be charged until the date that the creditor must automatically terminate coverage under applicable law.
- **Negative Amortization Loans (Section 226.18(s)(7)(v) of Regulation Z and Paragraph 226.18(s)(7)-1 of the Commentary)**
 - The original interim rule defines a "negative amortization loan" as a loan that permits payments that result in negative amortization. Only reverse mortgages subject to § 226.33 of Regulation Z are excluded.
 - The new interim rule narrows this definition. As revised, a "negative amortization loan" means a loan that requires a minimum periodic payment that covers only a portion of the accrued interest, which results in negative amortization.
 - Under this narrowed definition, some loans will result in negative amortization but will not be treated as "negative amortization loans" under the new interim rule.
 - The fact that a loan is not treated as a "negative amortization loan" under the new interim rule does not mean that it is not treated as a negative amortization loan for other purposes. See, e.g., the Interagency Guidance on Nontraditional Mortgage Product Risks.
 - Examples of negative amortization loans under the new interim rule:
 - Payment Option ARMs.
 - Similar "pick a payment" ARM loans.
 - Other loans that require minimum payments that do not cover the entire amount of interest that has accrued.
 - Examples of loans that are not negative amortization loans under the new interim rule:
 - ARMs that have an initial period of interest-only payments followed by a period of fully amortizing payments.
 - Loans requiring level, amortizing payments but having a payment schedule containing gaps during which interest accrues and is added to principal before the regular payments begin or resume (e.g., a seasonal income loan that provides for amortizing payments during nine months each year and no payments for the

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other three months – because all payments due are amortizing payments, the loan is not a negative amortization loan).

- An ARM that has fixed periodic payments that do not change when the interest rate adjusts. Here, while there is a possibility of negative amortization after consummation, there is not a certainty of negative amortization. In addition, this type of loan does not present the borrower with the choice of making a minimum payment or a larger payment.
 - ❖ The Board Staff appears to be assuming that the initial interest rate of this loan is a fully indexed rate.
 - ❖ Comment: The distinction between this type of loan – which is not a negative amortization loan – and a payment option ARM – which is a negative amortization loan – is somewhat thin.
- If a loan does not qualify as a “negative amortization loan” under the revised definition, then it is treated as an amortizing loan under the regulation. The rate and payment table for such a loan will not be based on Appendix H-4(G), the table that contrasts the full payment option and minimum payment option for each column.

• Construction Loans (Commentary to Appendix D of Regulation Z)

- The original interim rule contained no guidance regarding the use of the rate and payment table in the construction loan context. These issues are discussed in the new interim rule, which applies when the construction loan is secured by real property or a dwelling.
 - The new interim rule relates to those creditors that choose to provide Regulation Z disclosures for multiple-advance construction loans in accordance with Appendix D of Regulation Z. Virtually all creditors that make construction loans rely on Appendix D.
 - Where a creditor provides a construction loan that may be permanently financed by the creditor, the creditor has the option of disclosing the construction phase and the permanent phase as two separate transactions or as a single transaction. See § 226.17(c)(6)(ii) of Regulation Z. The new interim rule provides direction for both situations.
- If the construction phase is disclosed as a separate transaction (or, if the loan is a construction-only loan), then the interest rate and payment table contemplated by new § 226.18(s) – reflecting the interest rates and corresponding periodic payments for the construction phase – must be included in the Regulation Z disclosure statement. The creditor must also provide the balloon payment disclosure for the balloon payment that will be due at the maturity of the construction phase (or construction-only loan). The balloon payment disclosure is placed outside the interest rate and payment table. See § 226.18(s)(5) of Regulation Z and Model Clause H-4(J) in Appendix H of Regulation Z.
 - Where the construction phase is disclosed as a separate transaction (or, if the loan is a construction-only loan), and interest is payable only on amounts actually advanced, Appendix D currently does not require the disclosure of the payment schedule under § 226.18(g) of Regulation Z. Instead, the creditor need only disclose that interest payments are required and the timing of those payments. However, the interest rate and payment table is required by § 226.18(s), not § 226.18(g). As a result, the interest rate and payment

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table and the balloon payment clause for the construction phase (or construction-only loan) must be disclosed.

- If the construction phase and permanent phase are disclosed as a single transaction, the interest rate and payment table must reflect only the permanent phase. The interest rate shown in the first column of the table must reflect the interest rate corresponding to the first payment during the permanent phase. For the construction phase, assuming that interest is payable only on amounts actually advanced, the creditor must disclose that interest payments are required and the timing of those payments. This disclosure for the construction phase must appear outside of the interest rate and payment table.
- **Modification of Model Clause H-4(H) (Commentary to Appendices G and H of Regulation Z)**
 - Model Clause H-4(H) provides a model interest rate and payment table for fixed rate mortgages that contain an initial interest-only phase. As published in the original interim rule, this table shows two columns – an “Introductory Rate & Monthly Payment” column and a “Maximum Ever” column.
 - The Board’s Supplementary Information states that labeling the second column as “Maximum Ever” was a mistake, presumably because the “Maximum Ever” heading is to be used solely for ARMs and step-rate loans (while Model Clause H-4(H) is, by its terms, to be used solely for fixed rate loans). See § 226.18(s)(2)(i)(B)(3) of Regulation Z.
 - To resolve this situation, the Commentary states that creditors may modify the heading of the second column in Model Clause H-4(H) to read “First Increase.” The second column will reflect the first payment of principal and interest.
 - More specifically, the Commentary states that the second column may be modified to read “First Adjustment” or “First Increase,” as applicable. However, it is difficult to see how “First Adjustment” will ever be appropriate – the “First Adjustment” designation is to be used solely for ARMs, while Model Clause H-4(H) is, by its own terms, to be used solely for fixed rate loans. See § 226.18(s)(2)(i)(C) of Regulation Z.

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