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October 28, 2010

To: Clients and Friends

From: David F. Dulock

Subject: Federal Reserve Board Interim Rule Revises Payment Schedule Disclosures -
New §§226.18(s) and (t) of Regulation Z published in the *Federal Register*

In the September 24, 2010, issue of the *Federal Register* (75 F.R. 58470), the Board of Governors of the Federal Reserve System (FRB) published an interim rule (the Interim Rule) amending the payment schedule disclosure requirements in §226.18 of Regulation Z for closed-end mortgage loans for which a creditor receives applications on and after January 30, 2011. The Interim Rule revises the introductory text of §226.18(g), adds new §§226.18(s) and (t), revises and adds interpretive comments to Supplement I - Official Staff Interpretations, and adds new closed-end model clauses H-4(E) through H-4(K) to Appendix H-Closed-End Model Forms and Clauses. The Interim Rule implements those disclosure provisions of the Mortgage Disclosure Improvement Act of 2008 (Public Law 110-289, §§2501-2503) that amended Section 128 of the Truth in Lending Act (TILA), in pertinent part, by adding subsection 128(b)(2)(C) requiring disclosure of payment examples for loans whose interest rate or payments can change and a “no-guarantee-to-refinance” statement.

The Interim Rule will substantially affect the substance and format of the initial and final disclosures required by §226.18 of Regulation Z (herein “TILA disclosure”). Thus, the Interim Rule should be of immediate concern to the mortgage lending industry.

Although **compliance with the Interim Rule is mandatory on January 30, 2011**, the FRB intends to conduct additional testing and may revise the Interim Rule in light of further testing results. For this reason, the FRB is also soliciting comments on the Interim Rule. If you wish to submit comments, the FRB must receive them on or before November 23, 2010. The instructions for submitting comments to the FRB can found on page 58470 of the above-cited issue of the *Federal Register* in the section entitled “**ADDRESSES.**”

• **FRB SUMMARY**

The below summary of the Interim Rule, taken from the FRB’s August 16, 2010 press release, states that, under the Interim Rule, the TILA disclosure for closed-end mortgage loans must:

1. “[I]nclude a payment summary in the form of a table, stating the following:
 - The initial interest rate together with the corresponding monthly payment;
 - For adjustable-rate or step-rate loans, the maximum interest rate and payment that can occur during the first five years and a ‘worst case’ example showing the maximum rate and payment possible over the life of the loan; and
 - The fact that consumers might not be able to avoid increased payments by refinancing their loans.”
2. “[D]isclose certain features, such as balloon payments, or options to make only minimum payments that will cause loan amounts to increase.”

In order to assist you in understanding these new payment schedule disclosure requirements, the following is our redaction of the Interim Rule and the FRB's preamble explanatory statements published with the Interim Rule.

- **INTEREST RATE AND PAYMENT SUMMARY - §226.18(s)**

The new §226.18(s) disclosures required by the Interim Rule apply to closed-end consumer loans secured by a dwelling or by real property, whether or not a dwelling is located thereon, (herein "mortgage loan"). These new disclosures replace the current payment schedule disclosures in existing §226.18(g) for mortgage loans only. Thus, on and after January 30, 2011, amended §226.18(g) will apply only to closed-end consumer loans not secured by a dwelling or by real property and new §226.18(s) will apply only to mortgage loans.

For the purposes of §226.18(s), the following terms are defined in §226.18(s)(7):

1. *Adjustable-rate mortgage* means a loan in which the annual percentage rate may increase after consummation.
2. *Step-rate mortgage* means a loan in which the interest rate will change after consummation, and the rates and periods in which they will apply are known at consummation.
3. *Fixed-rate mortgage* means a loan that is not an adjustable-rate or step-rate mortgage.
4. *Interest-only* means that under the terms of the loan one or more periodic payments may be applied solely to interest and not to principal.
5. *Interest-only loan* means a loan that permits interest-only payments.
6. *Amortizing loan* means a loan in which the regular periodic payments cannot cause the principal balance to increase.
7. *Negative amortization* means that under the loan terms the periodic payments may cause the principal balance to increase.
8. *Negative amortization loan* means a loan with a negative amortization feature but explicitly excludes a reverse mortgage.
9. *Fully-indexed rate* means the interest rate calculated using the index value and margin at consummation.

The Interim Rule requires creditors to disclose the contract interest rate together with the corresponding periodic payment, including any escrows for taxes and property and/or mortgage insurance. The Interim Rule imposes special disclosure requirements for adjustable-rate and step-rate mortgages to show the interest rate and payment at consummation, the maximum interest rate and payment at any time during the first five years after consummation, and the maximum interest rate and payment possible during the life of the loan. The Interim Rule requires additional special disclosures for loans with negatively amortizing payment options, introductory interest rates, interest-only payments, and balloon payments. The headings and format of the table disclosing this information must be substantially similar to the following applicable Model Clause(s) in Appendix H to Regulation Z:

1. Model Clause H-4(E) illustrates the interest rate and payment summary table required for a fixed-rate mortgage.
2. Model Clause H-4(F) illustrates the table for an adjustable-rate or a step-rate mortgage.
3. Model Clause H-4(G) illustrates the table for a mortgage with negative amortization.

4. Model Clause H-4(H) illustrates the table for a fixed-rate mortgage with interest only terms.
5. Model Clause H-4(I) illustrates the introductory rate disclosure required if an adjustable-rate mortgage has an introductory rate.
6. Model Clause H-4(J) illustrates the balloon payment disclosure required for a mortgage with a balloon payment term.

The Addendum attached to this memorandum reproduces these Model Clauses exactly as they appear in Appendix H, and we advise you to refer periodically to the attached Addendum as an aid in understanding this memorandum's explanation of the Interim Rule's new disclosure requirements. The Interim Rule provides that a table that does not include the shading shown in the applicable Model Clause, but otherwise follows that Model Clause's headings and format, is considered substantially similar to that Model Clause.

Interest Rate and Payment Summary Table. Section 226.18(s)(1) requires the interest rate and payment information to be disclosed in a table that:

- (i) is in a minimum 10-point font;
- (ii) is placed in a prominent location in the TILA disclosure;
- (iii) has no more than five vertical columns corresponding to the disclosed interest rates, with the applicable periodic payments disclosed in horizontal rows; and
- (iv) must not include information that is not required by §226.18(s).

Interest Rate - Fixed-rate Mortgage. The rules for disclosing the interest rate for a fixed-rate mortgage are contained in §226.18(s)(2)(i)(A) and (C). For a fixed-rate mortgage with no scheduled payment increases or balloon payments, §226.18(s)(2)(i)(A) requires the disclosure only of the interest rate at consummation. For a fixed-rate mortgage with scheduled payment increases, §226.18(s)(2)(i)(C) requires the disclosure of the interest rate associated with each payment increase, even if the interest rate does not change.

Interest Rates - Adjustable-rate/Step-rate Mortgage. For these loans, §226.18(s)(2)(i)(B)(1) requires the disclosure of the interest rate at consummation and the period of time until the first adjustment. §226.18(s)(2)(i)(B)(2) requires the disclosure of the maximum possible rate at any time during the first five years after consummation, even if that is not the first adjustment, and the earliest date that rate may apply. For an adjustable-rate mortgage, if there are interest rate caps during the first five years after consummation, these caps must be taken into account when disclosing the maximum interest rate during the first five years and the earliest date that rate may occur. §226.18(s)(2)(i)(B)(3) requires the creditor to disclose the maximum interest rate that could apply at any time during the loan term, and the earliest date on which that rate could apply. Here, again, for an adjustable-rate mortgage, if there are interest rate caps, these caps must be taken into account when disclosing the maximum interest rate and the earliest date that rate may occur. However, if the maximum possible interest rate may be reached during the first five years, the interest rate and payment summary table will have only two columns – the first disclosing the interest rate at consummation and the second disclosing the maximum possible rate.

Interest Rate at Payment Increase - Amortizing Loan. For an amortizing loan that provides for a payment increase without an interest rate increase or adjustment (e.g., interest-only payments for a specified period followed by principal and interest payments for the remaining loan term), §226.18(s)(2)(i)(C) requires the creditor to include a column in the interest rate and payment summary table that discloses the interest rate that would apply at the time the payment increase is

scheduled to occur and the date on which the increase would occur. As stated above, for a fixed-rate mortgage, this means the disclosure of the same interest rate twice. For an adjustable-rate mortgage and a step-rate mortgage, if a scheduled payment increase does not coincide with an interest rate adjustment (adjustable-rate mortgage) or interest rate increase (step-rate mortgage), the creditor must include a column in the interest rate and payment summary table that discloses the interest rate that would apply at the time the first payment increase is scheduled to occur, the date on which the increase would occur, and, as applicable, the label “first adjustment” for a adjustable-rate mortgage or “first increase” for a step-rate mortgage. This requirement would also apply to those growth-equity mortgages in which the payment increases based on changes in an index, but without an interest rate increase (*see comment 17(c)(1)-13 for a complete explanation*).

Introductory Rate Disclosure. In an amortizing adjustable-rate mortgage with an introductory rate (*i.e.*, an initial rate that is below the fully-indexed rate), §226.18(s)(2)(iii) requires a special disclosure of the introductory rate. The special disclosure must be placed in a box (*see Model Clause H-4(I) attached*) directly beneath the interest rate and payment summary table and must disclose:

- (i) the introductory rate and how long it will last;
- (ii) that the interest rate will increase at the first scheduled adjustment, even if market rates do not increase, and the month or year of the adjustment; and
- (iii) the fully-indexed rate.

For the “early” TILA disclosure (*i.e.*, disclosures provided within three business days of application), the disclosed fully-indexed rate may be based on the index value in effect at the time the early TILA disclosure is provided. For the “final” TILA disclosure (*i.e.*, disclosures given at consummation or three business days prior to consummation, as applicable) the disclosed fully-indexed rate is based on the index value at consummation in accordance with the §226.18(s)(7) definition. However, for both the early TILA disclosure and the final TILA disclosure, if an amortizing adjustable-rate mortgage provides for an index value delay period, the disclosed fully-indexed rate may be based on an index value in effect anytime during the delay period. For example, if the adjustable-rate mortgage provides that interest rate changes are based on an index value in effect 45 days before a change date, the disclosed fully-indexed rate may be based on any index value in effect 45 days before consummation or earlier date of disclosure, as applicable.

Payments for Amortizing Loan. Under §226.18(s)(3)(i), if all periodic payments will be applied to accrued interest and principal, then, for each interest rate disclosed in the interest rate and payment summary table, §226.18(s)(3)(i)(A) requires disclosure of the corresponding periodic principal and interest payment listed in a single row in the table and labeled as “principal and interest.” In addition, if the periodic payment may increase without regard to an interest rate adjustment, 226.18(s)(3)(i)(B) requires disclosure of the payment that corresponds to the first such increase and the earliest date on which the increase could occur - for example, a fixed-rate mortgage might have scheduled payment(s) for an initial period in which the principal portion of the payments is insufficient to fully amortize the principal of the loan (*i.e.*, a partially amortizing payment). In that case, the interest rate and payment summary table also must disclose a scheduled increase in the payment amount from such a partially amortizing payment to a fully amortizing payment.

Escrows for Amortizing Loan. If an escrow account will be established, §226.18(s)(3)(i)(C) provides that the interest rate and payment summary table must disclose the estimated payment amount for taxes and insurance (*i.e.*, property taxes and hazard insurance, but not credit

protection insurance or debt suspension/cancellation agreements). The estimated payment amount for taxes and insurance must also include any mortgage insurance. For the mortgage insurance premiums, the estimated payment amount should reflect the consumer's mortgage insurance payments until the date on which the creditor must automatically terminate coverage under applicable law, even though the consumer may have a right to request that the insurance be canceled earlier. These periodic mortgage insurance payments must be reflected in the escrow amount even if mortgage insurance is not escrowed and even if there is no escrow account established for the loan. Other than mortgage insurance premiums, these estimated escrow amounts disclosed under §226.18(s)(3)(i)(C) do not affect any other disclosures, including the finance charge and annual percentage rate.

Total Periodic Payments for Amortizing Loan. For each interest rate disclosed, §226.18(s)(3)(i)(D) requires the interest rate and payment summary table to disclose in each column the total estimated monthly payment (*i.e.*, the sum of the principal and interest payments and escrow payments) and label this total payment "total estimated monthly payment" (*if the periodic payments are not due monthly, change "monthly" to the appropriate term, such as "quarterly" or "annually"*).

Interest-only Payments for Amortizing Loan. If the loan is an interest-only loan without a negative amortization feature, §226.18(s)(3)(ii) requires, for each interest rate disclosed in the interest rate and payment summary table, the corresponding periodic payment. If the payment will be applied to only accrued interest, the amount applied to interest must be disclosed, labeled as "interest payment," with a statement that none of the payment is being applied to principal. If the payment will be applied to accrued interest and principal, the earliest date that such payments will be required and an itemization of the amount applied to accrued interest and the amount applied to principal (labeled as "interest payment" and "principal payment," respectively) must be disclosed. In addition, the escrow information and the sum of all amounts (labeled as "total estimated monthly payment") must be disclosed in the same manner as described in the two paragraphs immediately above. ***Note: The rules in §226.18(s)(3)(ii) do not apply to a negative amortization loan with an interest-only feature. Payments for a negative amortization loan (even if it also has a negative amortization feature) are disclosed under the rules in §226.18(s)(4), discussed below.***

General - Negative Amortization Loan. The rules for disclosing the interest rates and periodic payments for a negative amortization loan and special disclosures rules for a negative amortization loan are set out in §§226.18(s)(2)(ii), 226.18(s)(4) and 226.18(s)(6), respectively, explained below. Be advised that negative amortization loans also include (i) payment option loans that allow the payment of minimum payments covering only some of the interest accruing each month, and (ii) those graduated-payment adjustable-rate mortgages in which the initial payment is insufficient to cover the scheduled interest (*see comment 17(c)(1)-12 for a complete explanation*).

Interest Rates - Negative Amortization Loan. §226.18(s)(2)(ii) requires the creditor to disclose the interest rate:

- (i) at consummation labeled "introductory" or "intro" and, if it will adjust after consummation, the length of time until it adjusts;
- (ii) the maximum interest rate that could apply when the fully amortizing payments begin;

(iii) if the minimum required payment will increase before the fully amortizing payments begin, the maximum interest rate that could apply at the time of the first payment increase and the date the increase is scheduled to occur; and

(iv) if a second increase in the minimum required payment may occur before the fully amortizing payments begin, the maximum interest rate that could apply at the time of the second payment increase and the date the increase is scheduled to occur.

For an adjustable-rate negative amortization loan, if there are interest rate caps, these caps must be taken into account when disclosing the maximum interest rate and the earliest date that the maximum interest rate may occur. If there are no rate caps, except the life-time cap, the maximum interest rate is disclosed at the first interest rate adjustment.

Payments for Negative Amortization Loan. For each interest rate or adjustment that §226.18(s)(2)(ii) requires to be disclosed, §226.18(s)(4) requires the interest rate and payment summary table to disclose the payments in two separate horizontal rows with no more than five vertical interest rate columns (*see Model Clause H-4(G) in attached Addendum*). The first row, labeled “Full Payment Option,” discloses the fully amortizing payment in each column of the table for each disclosed interest rate (*including the interest rate at consummation*) assuming the interest rate reaches the maximum at the earliest possible date and that only fully amortizing payments are made starting with the first scheduled payment under the loan. The Full Payment Option row of the table also must include a statement that the fully amortizing payment pays all principal and accrued interest. The second row, labeled “Minimum Payment Option,” discloses the minimum required payment in each column of the table for each disclosed interest rate or adjustment assuming the interest rate reaches the maximum at the earliest possible date and that only the minimum required payment is made for as long as permitted under the terms of the loan. The Minimum Payment Option row of the table must also include a statement that the minimum payment will cover only some of the accrued interest and none of the principal and will cause the principal balance to increase. If the increase in the minimum payment is limited (*e.g.*, 7.5% greater than the previous minimum payment), the Minimum Payment Option row of table must disclose the minimum payment amount at the first payment increase and, if necessary, at the second payment increase. When minimum payments no longer are permitted and fully amortizing payments are required under the loan, the Minimum Payment Option row of the table must disclose the fully amortizing payment based upon the disclosed maximum possible interest rate applicable at that time under the loan. Only two payment options are disclosed, even if the terms of the negative amortization loan provide for others, such as an option to make interest-only payments (*i.e.*, the table would show only the option to make minimum payments that would result in negative amortization, and the option to make fully amortizing payments).

Additional Disclosures for Negative Amortization Loan. §226.18(s)(6) requires the following information to be disclosed in close proximity to the interest rate and payment summary table (*see Model Clause H-4(G) for language and location*): (i) a statement that the loan offers payment options; (ii) a statement that the interest rate and payment summary table shows two of these options, which statement also must disclose the maximum possible interest rate and the shortest period of time in which the maximum interest rate could be reached; (iii) a statement whether an escrow account will be established and, if so, the amount of estimated taxes and insurance included in each disclosed periodic payment (*because only one escrow amount is disclosed under §226.18(s)(6) and escrows are not itemized in the payment amounts disclosed, the single escrow amount disclosed must reflect any mortgage insurance payment that is part of the escrow at outset of the loan’s term, even though the mortgage insurance payment will decline*

over the loan term and ultimately be discontinued); and (iv) the dollar amount of the increase in the loan's principal balance if only the minimum required payments are made for the maximum possible time and the earliest date on which the fully amortizing payments begin, assuming that the maximum interest rate is reached at the earliest possible time.

Balloon Payments. Under §226.18(s)(5), a balloon payment must be disclosed separately from the other periodic payments disclosed in the interest rate and payment summary table, outside and below the table and be substantially similar to Model Clause H-4(J) in Appendix H (*see attached Addendum*). If, however, a balloon payment coincides with an interest rate adjustment or scheduled payment increase (*e.g.*, the expiration of an interest-only option), the balloon payment must be disclosed in the table. A payment is a balloon payment if it is more than twice the amount of the regular periodic payments; but in a reverse mortgage, the single payment is not considered a balloon payment.

NO GUARANTEE TO REFINANCE STATEMENT - §226.18(t)

New §226.18(t) of the Interim Rule requires creditors to disclose on the TILA disclosure a statement that there is no guarantee the consumer will be able to refinance the loan to obtain a lower interest rate and payment. Although the Mortgage Disclosure Improvement Act of 2008 (MDIA) requires this refinancing statement only for a closed-end dwelling secured loan in which the interest rate and/or regular payments is variable, §226.18(t) expands the requirement to include all the mortgages loans defined in §226.18(s)(7). The statement must be made in a form substantially similar to Model Clause H-4(K) in Appendix H (*see attached Addendum*).

- **MANDATORY AND EFFECTIVE DATES**

Compliance with the Interim Rule is mandatory on January 30, 2011, for closed-end mortgage loans for which creditors receive applications on or after that date. The Interim Rule is effective, however on October 25, 2010, and **compliance with the Interim Rule is optional from October 25, 2010 until January 30, 2011**.

- **CONCLUSION**

We advise you not to rely exclusively on this memorandum in understanding and applying the the Interim Rule, but to read the text of and the explanatory preamble to the Interim Rule, which may be accessed at: <http://edocket.access.gpo.gov/2010/pdf/2010-20663.pdf>.

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Attachment: Addendum – H-4(E) to H-4(K) Model Clauses

ADDENDUM – H-4(E) TO H-4(K) MODEL CLAUSES

H-4(E) Fixed Rate Mortgage Interest Rate and Payment Summary Model Clause

INTEREST RATE AND PAYMENT SUMMARY

	Rate & Monthly Payment
Interest Rate	____%
Principal + Interest Payment	\$ ____
Est. Taxes + Insurance (Escrow) • [Includes [Private] Mortgage Insurance]	\$ ____
Total Est. Monthly Payment	\$ ____

H-4(F) Adjustable-Rate Mortgage or Step-Rate Mortgage Interest Rate and Payment Summary Model Clause

INTEREST RATE AND PAYMENT SUMMARY

	INTRODUCTORY Rate & Monthly Payment (for first (period))	[MAXIMUM during FIRST FIVE YEARS (date)]	MAXIMUM EVER (as early as (date))
Interest Rate	____%	[____%]	____%
Principal + Interest Payment	\$ ____	[\$ ____]	\$ ____
Est. Taxes + Insurance [(Escrow)] • [Includes [Private] Mortgage Insurance]	[\$ ____]	[\$ ____]	[\$ ____]
Total Est. Monthly Payment	\$ ____	[\$ ____]	\$ ____

H-4(G) Mortgage with Negative Amortization Interest Rate and Payment Summary Model Clause

INTEREST RATE AND PAYMENT SUMMARY

[This loan offers you several monthly payment options. The table below shows you what your payments would be under two of these options if the interest rate reached its maximum of ____% in the (period) of this loan.]

[All payments shown in the table include \$ ____ for estimated taxes and insurance [(escrow)].

	(Date) [[(period) [intro]]]	[(Date) (1st adjustment)]	[(Date) (2nd adjustment)]	(Date) + every (period) after
Maximum Interest Rate	____% [(intro rate)]	[____%]	[____%]	____% (max. ever)
Full Payment Option <i>Monthly payments cover all principal and interest.</i>	\$ ____	[\$ ____]	[\$ ____]	\$ ____
Minimum Payment Option <i>Initial monthly payments cover no principal and only some interest and increase your loan amount.</i>	\$ ____	[\$ ____]	[\$ ____]	\$ ____

You will borrow an additional \$ ____ by (date)
if you make only minimum payments on this loan.

H-4(H) Fixed Rate Mortgage with Interest Only Interest Rate and Payment Summary Model Clause

INTEREST RATE AND PAYMENT SUMMARY

	INTRODUCTORY Rate & Monthly Payment (for first ____ years)	MAXIMUM EVER (as early as ____)
Interest Rate	____%	____%
Principal Payment	- none -	\$ ____
Interest Payment	\$ ____	\$ ____
Est. Taxes + Insurance (Escrow)	\$ ____	\$ ____
Total Est. Monthly Payment	\$ ____	\$ ____

H-4(I)—Introductory Rate Model Clause

[Introductory Rate Notice

You have a discounted introductory rate of _____ % that ends after (period).

In the (period in sequence), even if market rates do not change, this rate will increase to ____ %.]

H-4(J)—Balloon Payment Model Clause

[Final Balloon Payment due (date): \$_____]

H-4(K)—“No-Guarantee-to-Refinance” Statement Model Clause

There is no guarantee that you will be able to refinance to lower your rate and payments.