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To: Clients and Friends

From: David F. Dulock

Subject: Federal Reserve Board Interim Rule Revises Prior Interim Rule Regarding Payment Schedule Disclosures -New §§226.18(s) and (t) of Regulation Z

In the December 29, 2010 issue of the *Federal Register* (75 FR 81836), the Board of Governors of the Federal Reserve System (FRB) published an interim rule (Dec.-Rule) making technical revisions to its September 24, 2010 interim rule (Sept.-Rule), which implemented certain requirements of the 2008 Mortgage Disclosure Improvement Act, that required disclosure of payment examples if the loan's interest rate or payments can change. (See our memorandum dated October 28, 2010, posted on our Web site at: <http://www.bmandg.com/Articles/ArticleView/tabid/94/smid/426/ArticleID/84/Default.aspx>.)

The purpose of this memorandum is to (1) advise you of the FRB's Dec.-Rule revisions to the Sept.-Rule, and (2) to amend our October 28, 2010 memorandum. In order to have a complete understanding of the Sept.-Rule and its Dec.-Rule revisions, you will need to read both memoranda.

The FRB issued the Dec.-Rule to revise and clarify the Sept.-Rule, as follows:

1. clarify the requirements for "5/1 ARM" adjustable-rate loans;
2. correct the requirements for interest-only loans to clarify that the disclosures should reflect the date of the interest rate change rather than the date the first payments of principal and interest are due under the new rate;
3. revise the definition of "negative amortization loan" to clarify which loans are covered by the special disclosure requirements for such loans;
4. clarify how the Sept.-Rule applies to multiple- advance construction loans; and
5. make other technical revisions and clarifications.

- ***Summary of the Sept.-Rule***

Under the Sept.-Rule, beginning with loan applications received on or after January 30, 2011, creditors are required to disclose in a tabular format the contract interest rate together with the corresponding monthly payment, including an estimated amount for any escrows for taxes and property and/or mortgage insurance. Special disclosure requirements are imposed for adjustable-rate or step-rate loans 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. Additional special disclosures are required for loans with negatively amortizing payment options, introductory interest rates, interest-only payments, and balloon payments. Finally, the Sept.-Rule requires the disclosure of a statement that there is no guarantee the consumer will be able to refinance the loan with a new transaction in the future.

- ***Summary of the Dec.-Rule Revisions for 5/1 ARM Loans - §226.18(s)(2)(i)(B)(2)***

To ensure that the first rate adjustment will be disclosed for 5/1 ARM loans, the Dec.-Rule revises §226.18(s)(2)(i)(B)(2) of the Sept.-Rule. The Sept.-Rule's existing requirement provides that for adjustable-rate (and step-rate) mortgages, creditors should disclose the maximum interest rate and payment during the first five years after consummation. As modified by the Dec.-Rule, creditors must base their disclosures on the first five years after the first regular periodic payment due date, rather than the first five years after consummation. As revised by the Dec.-Rule, §226.18(s)(2)(i)(B)(2) now reads, "The maximum interest rate that may apply during the first five years after the date on which the first regular periodic payment will be due and the earliest date on which that rate may apply, labeled as 'maximum during first five years'; and"

- ***Summary of the Dec.-Rule Revisions for Interest-only Loans - §226.18(s)(3)(ii)(B); Comment 18(s)(2)(i)(C)-1***

The Dec.-Rule clarifies the requirements in the Sept.-Rule for disclosing the payments on an interest-only loan. Under the Sept.-Rule, for each interest rate disclosed, the creditor must disclose the earliest date that rate may apply and the corresponding periodic payment. In addition, for an interest-only loan, if the corresponding payment will be applied to both accrued interest and principal, the Sept.-Rule further requires the creditor to disclose the earliest date that such payment will be required. To eliminate the potential conflict from disclosing two different dates in the same column for interest-only loans (*i.e.*, the interest rate date and the payment date), the Dec.-Rule revises §226.18(s)(3)(ii)(B) by removing the requirement to disclose the earliest date on which the payments of principal and interest will be required. The Dec.-Rule also adds language to clarify that only the first such payment is required to be disclosed. Thus, by revising §226.18(s)(3)(ii)(B), the Dec.-Rule provides the following clarification for interest-only loans: (1) only the earliest date the interest rate becomes effective is disclosed, and (2) the itemized amounts disclosed as applied to interest and to principal are those amounts for the first such payment only. As revised by the Dec.-Rule, §226.18(s)(3)(ii)(B) now reads, "If the payment will be applied to accrued interest and principal, an itemization of the amount of the first such payment applied to accrued interest and to principal, labeled as 'interest payment' and 'principal payment,' respectively;."

The Dec.-Rule revises comment 18(s)(2)(i)(C)-1 of the Regulation Z Official Staff Interpretations (Reg. Z Commentary) to clarify that §226.18(s)(2)(i)(C)'s disclosure requirement applies to interest-only loans, if the payment can increase as described in §226.18(s)(3)(i)(B) (*i.e.*, payment increase without interest rate adjustment) even if it is not the type of loan covered by §226.18(s)(3)(i) (*i.e.*, all periodic payments applied to principal and interest). Minor payment variations resulting from different numbers of days in months are disregarded.

- ***Summary of the Dec.-Rule Revisions for Negative Amortization Loans - §226.18(s)(7)(v); Comment 18(s)(7)-1***

The Dec.-Rule revises the definition of "negative amortization loan" to clarify which loans are covered by the Sept.-Rule's special negative amortization disclosure requirements in §§226.18(s)(2)(ii) and 226.18(s)(4). Those disclosures are designed to show consumers (1) how their periodic payments could increase over time and (2) the effects of making minimum

payments that result in negative amortization in comparison to the effects of making fully amortizing payments. The Dec.-Rule revisions clarify that these disclosures apply only to loans where consumers are allowed to make minimum payments that result in negative amortization. Thus, the revised definition of “negative amortization loan” excludes loan products that do not have a minimum required payment that results in negative amortization. For example, some loans that are designed for borrowers with seasonal employment require periodic amortizing payments but do not require payments in certain months; during months when no payment is made the accrued interest increases the principal balance. Also, some adjustable-rate loans provide for fixed periodic payments that do not adjust when the interest rate adjusts; in cases where the interest rate increases during the loan term, the additional accrued interest increases the principal balance. As clarified by the Dec.-Rule, the special disclosure requirements for negative amortization loans do not apply to such loans, even though some negative amortization can occur because of the capitalization of accrued interest during the loan term. To cover the disclosure requirements for such loans, and other loans that do not meet the Dec.-Rule’s revised definition of negative amortization loan (even if they have negative amortization), the Dec.-Rule adds new comment 18(s)(7)-1 to the Reg. Z Commentary to clarify that they are amortizing loans and will be disclosed under the amortizing loan rules in §§226.18(s)(2)(i), (iii) and 226.18(s)(3).

To accomplish the above, the Dec.-Rule revises the definition of “negative amortization loan” in §226.18(s)(7)(v) by removing the words “permits payments resulting in negative amortization” and adding in their place the words “that provides for a minimum periodic payment that covers only a portion of the accrued interest, resulting in negative amortization.” As amended in pertinent part, §226.18(s)(7)(v) now reads, “the term ‘negative amortization’ means payment of periodic payments that will result in an increase in the principal balance under the terms of the legal obligation; the term ‘negative amortization loan’ means a loan, other than a reverse mortgage subject to § 226.33, that provides for a minimum periodic payment that covers only a portion of the accrued interest, resulting in negative amortization.”

- ***Summary of the Dec.-Rule Revisions for Multiple-Advance Construction Loans – Comment App. D-6 to Appendix D***

The Dec.-Rule clarifies how the provisions in the Sept.-Rule apply to multiple-advance home construction loans. New comment App. D-6 of the Reg. Z Commentary clarifies that when a multiple-advance construction loan secured by real property or a dwelling that may be permanently financed by the same creditor is disclosed as more than one transaction, the construction financing must be disclosed under the new rules in §226.18(s). But, if the creditor discloses the construction and permanent financing as a single transaction, the interest rate and payment summary table required by §226.18(s) should reflect only the permanent financing, while the construction financing should be disclosed only with a statement outside the table that interest payments must be made and the timing of such payments.

New comment App. D-6 to Appendix D is self-explanatory and is set out in its entirety below:

6. *Relation to §226.18(s).* A creditor must disclose an interest rate and payment summary table for transactions secured by real property or a dwelling, pursuant to §226.18(s), instead of the general payment schedule required by §226.18(g). Accordingly, home construction loans that are secured by real property or a dwelling are subject to §226.18(s) and not §226.18(g).

Under §226.17(c)(6)(ii), when a multiple-advance construction loan may be permanently financed by the same creditor, the construction phase and the permanent phase may be treated as either one transaction or more than one transaction.

i. If a creditor uses Appendix D and elects pursuant to §226.17(c)(6)(ii) to disclose the construction and permanent phases as separate transactions, the construction phase must be disclosed according to the rules in §226.18(s). Under §226.18(s), the creditor must disclose the applicable interest rates and corresponding periodic payments during the construction phase in an interest rate and payment summary table. The provision in Appendix D, Part I.A.3, which allows the creditor to omit the number and amounts of any interest payments “in disclosing the payment schedule under §226.18(g)” does not apply because the transaction is governed by §226.18(s) rather than §226.18(g). Also, because the construction phase is being disclosed as a separate transaction and its terms do not repay all principal, the creditor must disclose a balloon payment, pursuant to §226.18(s)(5).

ii. On the other hand, if the creditor elects to disclose the construction and permanent phases as a single transaction, the construction phase must be disclosed pursuant to Appendix D, Part II.C, which provides that the creditor shall disclose the repayment schedule without reflecting the number or amounts of payments of interest only that are made during the construction phase. Appendix D also provides, however, that creditors must disclose (outside of the table) the fact that interest payments must be made and the timing of such payments. The rate and payment summary table disclosed under §226.18(s) must reflect only the permanent phase of the transaction. Therefore, in determining the rates and payments that must be disclosed in the columns of the table, creditors should apply the requirements of §226.18(s) to the permanent phase only. For example, under §226.18(s)(2)(i)(A) or §226.18(s)(2)(i)(B)(1), as applicable, the creditor should disclose the interest rate corresponding to the first installment due under the permanent phase and not any rate applicable during the construction phase.

- ***Summary of the Dec.-Rule Technical Revisions: Total of Payments Calculation – Comment 18(h)-2***

Comment 18(h)-2 of the Reg. Z Commentary states that the “total of payments” disclosure required by §226.18(h) is the sum of the payments disclosed in the payment schedule under §226.18(g). Since there is no payment schedule disclosed under §226.18(g) for loans subject to §226.18(s), the Dec.-Rule clarifies how to calculate the total of payments for loans subject to §226.18(s) by adding the following sentence to comment 18(h)-2: “To calculate the total of payments amount for transactions subject to §226.18(s), creditors should use the rules in §226.18(g) and associated commentary and, for adjustable-rate transactions, comments 17(c)(1)-8 and –10.”

- ***Summary of the Dec.-Rule Technical Revisions: Reference to Payment Periods Other than Monthly - Comment 18(s)-1***

The Dec.-Rule amends comment 18(s)-1 of the Reg. Z Commentary to clarify that references to “monthly” payments in the §226.18(s) disclosures may be modified to reflect other periods when applicable (e.g., when payments are due bi-weekly, quarterly or annually). Although comment 18(s)(3)(i)(D)-1 already provides this clarification for the total monthly payment disclosure for amortizing loans, there was no such guidance for the model clauses or the other §226.18(s) payment provisions. As amended in pertinent part, comment 18(s)-1 now reads,

“Where §226.18(s)(2)-(4) or the applicable model clause requires that a column or row of the table be labeled using the word “monthly” but the periodic payments are not due monthly, the creditor should use the appropriate term, such as ‘bi-weekly’ or ‘quarterly’.”

- ***Summary of the Dec.-Rule Technical Revisions: Escrow Payments for Taxes and Insurance - §226.18(s)(3)(i)(C); Comment 18(s)(3)(i)(C)-1***

The Dec.-Rule revises §226.18(s)(3)(i)(C) and comment 18(s)(3)(i)(C)-1 of the Reg. Z Commentary to clarify when disclosure of the estimated taxes and insurance escrow payment (escrow payment) is required and how to estimate the escrow payment when it is disclosed in connection with changes in the periodic payments.

Because the text of §226.18(s)(3)(i)(C) in the Sept.-Rule (I) states that when an escrow account is required, the requirement must be disclosed and (2) could be construed to require the escrow payment disclosure only if an escrow account is required (which was not the intent of the Sept.-Rule), the Dec.-Rule revises §226.18(s)(3)(i)(C) by removing the words “That an escrow account is required, if applicable,” and replacing them with “If an escrow account will be established,” so that §226.18(s)(3)(i)(C) now reads, “If an escrow account will be established, an estimate of the amount of taxes and insurance, including any mortgage insurance, payable with each periodic payment; and”. Thus, revised §226.18(s)(3)(i)(C) removes the requirement for a statement that an escrow account is required and clarifies that the escrow payment disclosure is required in all cases when an escrow account will be established, whether or not it is required.

The Dec.-Rule revises comment 18(s)(3)(i)(C)-1 to clarify that when escrow payments are disclosed in multiple columns of the interest rate and payment summary table, each column should reflect the same estimate for taxes and insurance except that the estimate should take into account changes in the periodic mortgage insurance premiums that are known at the time the disclosure is made, which should be based on the declining principal balance resulting from changes to the disclosed interest rates. Thus, revised comment 18(s)(3)(i)(C)-1, in pertinent part, now reads:

If the escrow account will include amounts for items other than taxes and insurance, such as homeowners association dues, the creditor may but is not required to include such items in the estimate. When such estimated escrow payments must be disclosed in multiple columns of the table, such as for adjustable- and step-rate transactions, each column should use the same estimate for taxes and insurance except that the estimate should reflect changes in periodic mortgage insurance premiums that are known to the creditor at the time the disclosure is made. The estimated amounts of mortgage insurance premiums should be based on the declining principal balance that will occur as a result of changes to the interest rate that are assumed for purposes of disclosing those rates under §226.18(s)(2) and accompanying commentary.

- ***Summary of Dec.-Rule Technical Revisions: Appendices G and H (Model Forms & Clauses) – Comment App. G and H-1***

The Dec.-Rule amends comment App. G and H-1 of the Reg. Z Commentary to permit creditors to modify the heading of the second column in Model Clause H-4(H), the “Fixed Rate

Mortgage with Interest Only” model clause, to read “first adjustment” or “first increase,” as applicable, to correct a discrepancy between §226.18(s)(2)(i)(C) and Model Clause H-4(H) in the Sept.-Rule. Although §226.18(s)(2)(i)(C) states the second column heading must be labeled as “first adjustment” if the loan is an adjustable-rate mortgage or, otherwise, labeled as “first increase,” the second column heading in the Sept.-Rule Model Clause H-4(H) is incorrectly labeled “maximum ever.”

Comments on Dec.-Rule

The FRB is requesting comments on the Dec.-Rule. All comments must be received by the FRB on or before February 28, 2011. You may submit comments, identified by Docket No. R-1366, by any of the following methods:

- Agency Web Site: <http://www.federalreserve.gov>. Follow the instructions for submitting comments at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm>.
- Federal eRulemaking Portal: <http://www.regulations.gov>. Follow the instructions for submitting comments.
- E-mail: regs.comments@federalreserve.gov. Include the docket number in the subject line of the message.
- Fax: (202) 452-3819 or (202) 452-3102.
- Mail: Address to Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, DC 20551.

Effective and Mandatory Dates

Although the effective date of the Dec.-Rule is January 30, 2011, compliance is optional until October 1, 2011. But, the January 30, 2011 mandatory date for complying with the Sept.-Rule remains unchanged.

Conclusion

We advise you not to rely exclusively on this memorandum in understanding and applying the the Dec.-Rule, but to read the text of and the explanatory preamble to the Dec.-Rule, which may be accessed at: <http://origin.www.gpo.gov/fdsys/pkg/FR-2010-12-29/pdf/2010-32534.pdf>. The Government Printing Office recently switched to a digital format, so there is a considerable delay after you click on the above Web address – just be patient.

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