

Client Alert.

August 20, 2010

New Interim Rule Requiring Disclosure of Interest Rate and Payment Summary for Mortgage Transactions

By Joseph Gabai

BACKGROUND

On August 16, 2010, the Federal Reserve Board (“Board”) issued two proposed rules and three final rules governing federal Truth-in-Lending Act (“TILA”) requirements for residential mortgage loans. This Client Alert summarizes the Board’s interim rule that requires the disclosure of an interest rate and payment summary for mortgage loans.

Later Client Alerts will address the Board’s remaining proposals and final rules.

CURRENT RULE

The payment schedule disclosure for closed-end loans is generally governed by Section 226.18(g) of Regulation Z, which requires a disclosure of the number, amounts, and timing of payments scheduled to repay the obligation. For mortgage loans with introductory interest rates, rate caps, payment caps, interest-only features, negative amortization, mortgage insurance, step rate, step payment, or other unique features, the payment schedule will have multiple phases—often, five or more—each set forth on a separate line.

INTERIM RULE

The Board’s interim rule was issued under the Mortgage Disclosure Improvement Act of 2008 and amends Regulation Z. The 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. Compliance with the new rule is optional until January 30, 2011. Compliance is mandatory for applications received on or after that date. Comments on the interim rule may be provided to the Board for 60 days following publication in the Federal Register. Other amendments affecting payment disclosures are likely at a later time.

Under the interim rule, the payment schedule disclosure requirements contained in Section 226.18(g) of Regulation Z remain in place, but will apply only to loans that are *not* secured by real property or a dwelling. For loans that *are* secured by real property or a dwelling, a new Section 226.18(s) will govern. Section 226.18(s) requires an interest rate and payment summary for these mortgage transactions, rather than an exact payment schedule reflecting every payment due for every phase of the loan. Moreover, Section 226.18(s) requires disclosure of the interest rates that are applicable at various times during the loan term, something that Section 226.18(g) neither requires nor tolerates. In addition, a new Section 226.18(t) will require a disclosure that there is no guarantee that the consumer can refinance the loan to lower the interest rate or periodic payments.

Client Alert.

Highlights of the new interim rule include the following:

- The information must be provided in the form of a table, with headings and formats substantially similar to Model Clauses H-4(E) [for fixed rate mortgages], H-4(F) [for adjustable rate mortgages (“ARMs”) or step rate mortgages], H-4(G) [for mortgages with negative amortization features, including Option ARMs], and H-4(H) [for fixed rate mortgages with an interest-only feature]. All loan products must be disclosed using the applicable Model Form.
- Only information required by the interim rule may be included in the table. The table must be placed in a prominent location in the Regulation Z disclosure, and it must contain a minimum 10-point font. While each of the Model Forms contains a shaded section, it is not necessary to include the shading in the form used by the creditor. Nevertheless, it would be desirable to include the shading, and most creditors presumably will do so.
- The interim rule is sufficiently flexible to accommodate a wide range of loan features, and the number of columns and the contents of the table will depend on the specific characteristics of the loan product. In any event, no more than five columns are permitted. Each column contains the interest rate that will apply at a designated time during the loan term, and the various rows will reflect the payments that are due.
- Section 226.18(s) of Regulation Z and the corresponding provisions of the Federal Reserve Commentary (“Commentary”) provide directions for disclosing the interest rates at various points of time for both amortizing loans (fixed rate, adjustable rate, step rate, and step payment) and negative amortization loans. There also are directions for disclosing the payments for amortizing loans (principal and interest payments, as well as interest-only payments) and negative amortization loans.
- For example, in the case of a simple fixed rate, fully amortizing payment loan, the table will be very straightforward—a single column showing the interest rate and then (in successive rows) the principal and interest payment, estimated taxes and insurance (including mortgage insurance) if there is an escrow account, and the total estimated payment.
- In contrast, in the case of a “plain vanilla” ARM with a capped rate during the first five years, there will be a disclosure of those same payment rows for each of three columns—the initial rate and payment, the maximum rate and payment during the first five years, and the maximum possible interest rate and payment. The Board has solicited specific comment as to whether five years is the appropriate period.
- If the loan has an interest-only period, the creditor must also disclose the first payment that will be applied to both principal and interest. For example, if the ARM has an introductory rate for five years and an interest-only period of three years, there would be four columns—the initial rate and payment (itemized to show that the payment is an interest-only payment), the interest rate and payment when the interest-only period ends, the maximum rate and payment during the first five years, and the maximum possible rate and payment.
- More complicated rules apply to loans with negative amortization. For a typical Option ARM product with a 7.5% payment cap except every five years, a maximum balance of 115% of the original balance, and no rate caps, there will (depending upon the other loan terms) be a need to show four columns. The first column will show the initial rate and minimum payment, the second column will show the maximum rate and minimum payment at the beginning of the second year (taking the 7.5% payment cap into consideration), the third column will show the

Client Alert.

maximum rate and minimum payment at the beginning of the third year (taking the 7.5% payment cap into consideration), and the fourth column will show the maximum rate and fully amortizing payment. The minimum payment option must be accompanied by a disclosure that it pays only some interest, does not repay principal, and that it will cause the loan amount to increase. A second row must reflect the fully amortizing payment option for each interest rate, if the loan product allows that option. Even if the loan product provides other payment options (as these products typically do), these may not be disclosed. Payments must include the estimated taxes and insurance (including mortgage insurance) if there is an escrow account. Various other disclosures are required for negative amortization loans.

- Additional disclosures are required if there is an introductory rate (*i.e.*, a rate that is less than the fully-indexed rate) or a balloon payment (*i.e.*, a payment that is more than twice as large as a regular payment). Further, in all cases—even for a simple fixed rate, fully amortizing loan—there must be a disclosure of the fact that there is no guarantee that the borrower will be able to refinance to lower his/her rate and payments. These disclosures, set forth in Appendices H-4(I), H-4(J) and H-4(K), must be provided below the table.
- There are various nuances. For example, a balloon payment that is due at the same time as another payment must be disclosed in the table, not below the table. Rate caps must be taken into consideration when disclosing the maximum rate during the first five years and during the life of the loan. For both an ARM and a step rate loan, the highest rate that can apply must be disclosed. A loan with an interest-only feature but which permits negative amortization will be disclosed using the negative amortization table. For an amortizing loan (both fixed rate and adjustable rate) where the payment can increase without regard to an interest rate adjustment, there is a need to disclose the payment that corresponds to the first such increase and the earliest date it could occur, subject to the overall rule that no more than five columns can be disclosed.
- When providing the introductory rate disclosure for an ARM, it is necessary to know the “fully-indexed rate.” The fully-indexed rate is the index plus the margin at consummation. For this purpose, “at consummation” refers to the disclosures delivered at the consummation of the loan (or three business days before consummation, if there is a redisclosure under Section 229.19(a)(2)(ii) of Regulation Z). For the early Regulation Z disclosure, the fully-indexed rate may be based on the index in effect when the disclosure is provided. If the loan product provides a “look back period” in the determination of rate adjustments, that same look back period can be used to identify the index value for purposes of determining the fully-indexed rate. For example, if the loan provides for a 45-day look back period, the creditor can use any index value in effect during the 45 days before consummation (or any earlier date of disclosure) in calculating the fully-indexed rate. This approach is consistent with Paragraph 226.17(c)(1)-10.
- The estimated amount for taxes and insurance must be disclosed in the table, as described above, if there will be an escrow account. The escrow amount must include mortgage insurance premiums even if they are not escrowed and even if no escrow account is actually established.
- In determining the amount of mortgage insurance premiums that will be reflected in the table, the creditor must assume that mortgage insurance premiums will continue to be charged (in the amounts required) until the date that the creditor must automatically terminate coverage under applicable law. This is the case even if the borrower has the legal right to cancel mortgage insurance coverage at some earlier time. For example, if the loan is subject to the federal Homeowners Protection Act, this means that the creditor must assume that mortgage

Client Alert.

insurance premiums will continue to be charged until the “termination date,” rather than the earlier “cancellation date” on which the borrower may request cancellation under certain conditions. This approach is consistent with existing Paragraph 226.18(g)-5 of the Commentary.

- The table for negative amortization loans requires a separate disclosure of the amount of estimated taxes and insurance. This is contained in a sentence that appears above the various columns. This sentence should reflect the mortgage insurance amount that will be collected at the outset of the loan term. In contrast, the mortgage insurance amounts included in the payments in the table should be calculated based on the rules summarized in the preceding paragraph.

ANALYSIS

- The interim rule involves an extraordinary departure from the Board’s historical approach to disclosure of the borrower’s payments. Instead of requiring an exact payment schedule reflecting every payment due for every phase of the loan, the interim rule provides a summary of the interest rates and payments that will apply at critical times during the scheduled term of the loan. This approach reflects the results of extensive consumer research that was conducted for the Board by an outside company. An underlying philosophy of the new tables is that borrowers should not suffer from information overload, and that sometimes less information is better than more. In short, the interim rule provides borrowers with what they say they want and need, rather than providing them with a detailed description of all of the payment information relevant to their loans.
- Because every loan product has its own unique characteristics, the interim rule and related Commentary provide generalized rules and some examples, rather than attempting to provide specific guidance for every conceivable type of loan. As confusing as the rules may seem, the Model Forms provided by the interim rule are remarkably clear and understandable—the best adjective might be “elegant.” For most loan products, it will be less difficult to populate the tables than might appear at first glance.
- Historically, creditors had the choice of whether to include escrows in the monthly payment schedule required by Section 226.18(g) of Regulation Z. See Paragraph 226.18(g)-1 of the Commentary. In practice, very few creditors chose to include the escrows in their disclosed payment schedules. Under new Section 226.18(s), creditors no longer have a choice. They will be required to disclose the estimated monthly escrow payment for taxes and insurance (including mortgage insurance) in all of the tables. In all of the tables other than the table for negative amortization loans, the creditor is required to separately disclose the monthly principal/interest payments, the monthly escrow payments, and the monthly total payments. In the table for negative amortization loans, the creditor is required to disclose payments for the fully amortizing payment option (if applicable) and the minimum payment option, with both sets of payments including the escrow payments.
- The Wall Street Reform and Consumer Financial Protection Act of 2010 (“Dodd-Frank Act”) amends the TILA’s disclosure requirements for closed-end mortgage loans in several respects. Section 1419 of the Dodd-Frank Act amends Section 128(a) of TILA to require, in the case of a residential mortgage loan with a variable rate, a disclosure of the initial monthly payment for the payment of principal and interest, as well as the amount of that payment together with the monthly escrows for the payment of all applicable taxes, insurance, and other assessments. Similarly, there is a need to disclose the fully-indexed monthly payment of principal and interest, as well as the amount of that payment together with the monthly escrows for the payment of all applicable taxes,

Client Alert.

insurance, and other assessments. In contrast, Section 1465 of the Dodd-Frank Act amends Section 128(b)(4) of TILA to require, in the case of a consumer credit transaction secured by a first lien on a principal dwelling (excluding open-end credit plans and reverse mortgages) for which an escrow account is required, a payment schedule that takes into account the amount of the periodic escrow payments. There are differences in the requirements of the interim rule, the amended Section 128(a) of TILA, and the amended Section 128(b)(4) of TILA, and the Board will need to sort these out in its implementing regulations.

- The Commentary states that it is not permissible to include premiums for credit insurance or debt suspension or cancellation agreements as part of the disclosed escrow payment in the tables. If the purchase of any such insurance or agreements is mandatory, the associated premiums become part of the finance charge. See Section 226.4(b)(7),(10) and (d)(1),(3) of Regulation Z, and the corresponding Commentary provisions. Under Section 226.18(g) of Regulation Z, those premiums must be disclosed as part of the payment schedule. See Paragraph 226.18(g)-1 of the Commentary. In contrast, new Section 226.18(s) contains no requirement for the disclosure of such mandatory premiums as part of the payment schedule summary. However, the mandatory premiums would be part of the disclosed finance charge.
- The Regulation and Commentary do not address whether it is permissible to include other escrowed items, such as ground rents, as part of the disclosed escrow payment. Presumably, the explicit reference in the Regulation and Commentary to the inclusion of taxes and insurance in the disclosed escrow payment means just that.
- For high-cost mortgages, creditors must provide an additional disclosure at least three business days before the consummation of the loan transaction. See Section 226.31(c)(1) of Regulation Z. Among other items, this disclosure must include an exact payment schedule reflecting every payment due for every phase of the loan. See Section 226.32(c)(3) of Regulation Z and Paragraph 226.32(c)(3)-1 of the Commentary. Creditors that make high-cost mortgages will be required to provide both the interest rate and payment summary required by new Section 226.18(s) and the exact payment schedule required by Section 226.32(c)(3), notwithstanding the fact that these may look very different.
- Loans secured by consumers' interests in certain timeshare plans are not subject to new Section 226.18(s) and (t) of Regulation Z. For those loans, Section 226.18(g) continues to apply, and the exact payment schedule must be disclosed in accordance with the requirements of that section and corresponding provisions of the Commentary. Reverse mortgages are subject to Section 226.18(s) and (t) of Regulation Z. However, reverse mortgages are excluded from the definition of a "negative amortization mortgage" for purposes of the interim rule. The vast majority of closed-end reverse mortgages carry a fixed rate, which means that those mortgages would be disclosed using the fixed rate table.
- As noted above, additional disclosures are required if there is an introductory rate (*i.e.*, a rate that is less than the fully-indexed rate). In many instances, the initial interest rate of an ARM is set by the creditor in accordance with market conditions at the time. If the initial rate is less than the fully-indexed rate, the introductory rate disclosure will be required. This result applies even if the creditor does not intend to offer a "teaser rate" designed to attract borrowers to the loan.
- For negative amortization mortgages, only two payment rows are allowed—one for the fully amortizing payment (if applicable) and one for the minimum payment. The Board's Supplementary Information states that information

Client Alert.

relating to other payment options may be placed “outside the segregated information required under [Section 226.18(s)].” Notwithstanding this language, it may be risky to include information on other payment options in the so-called “Federal Box.” Only “directly related” information may be included in the Federal Box, and the Commentary’s list of items that constitute “directly related information” does not include such payment options. See Paragraph 226.17(a)(1)-5 of the Commentary. If a creditor wishes to disclose information regarding the additional payment options, it would be prudent to provide that information outside of the Federal Box.

- The interim rule applies to all closed-end consumer credit transactions secured by real property or a dwelling. This means that new Section 226.18(s) and (t) of Regulation Z applies to a consumer loan secured by land that contains no dwelling or other structure whatsoever. The Board’s reasoning is that unimproved real property is likely to be a significant asset for most consumers.
- The Board’s Supplementary Information states that both consumer advocates and some industry commenters argued that the tables should reflect estimates of taxes and insurance even if no escrow accounts are established. The Board will conduct additional testing to determine whether this approach is feasible and would be helpful to consumers. Creditors that would be concerned by such a requirement may wish to submit a comment to the Board.

Contact:

Joseph Gabai
(213) 892-5284
jgabai@mofo.com

Andrew M. Smith
(202) 887-1558
andrewsmith@mofo.com

Sean Ruff
(202) 778-1665
sruff@mofo.com

About Morrison & Foerster:

We are Morrison & Foerster—a global firm of exceptional credentials in many areas. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life science companies. We’ve been included on *The American Lawyer’s* A-List for seven straight years, and *Fortune* named us one of the “100 Best Companies to Work For.” Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofo.com.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.