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CREDIT UNION EXECUTIVE NEWS

May 24, 2011

Inside this issue:

Appraisal Requirements	1
Loan Originator Comp	5
MDIA Disclosure Revisions	7
Process to Simplify Real Estate Loan Disclosures	9

APPRAISAL REQUIREMENTS—REG. Z INDEPENDENCE AND INTERAGENCY GUIDANCE

In an effort to make as many changes as possible to the real estate lending process before the Consumer Financial Protection Bureau officially assumes power, the NCUA and the Federal Reserve Board (FRB) have imposed significant new requirements regarding appraisals and property valuations used in real estate secured transactions.

The FRB issued an amendment to Regulation Z that requires separation of all aspects of the appraisal function from the "loan production function." The NCUA adopted uniform agency guidance on appraisals that imposes a significant new requirement on the use of automated valuation models, and sets out in detail the agency's expectations for other aspects of a credit union's appraisal and valuation policies and practices.

This article summarizes the key aspects of the FRB appraiser independence regulation, the new requirement for automated valuation models, and the other requirements of the interagency guidance on appraisals and valuations.

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1. FRB APPRAISER INDEPENDENCE RULE.

Section 1472 of the Dodd-Frank Act included several requirements and restrictions related to appraiser independence, most of which were unremarkable (i.e., prohibition on bribery and coercion in connection with appraisals, prohibition on extensions of credit by a lender that is aware of coercion or conflict of interest in appraisal).

It also required the FRB to issue regulations "defining with specificity acts or practices that violate appraisal independence in the provision of mortgage lending services." The Dodd-Frank also provides that when the FRB issued its new regulation, the Home Valuation Code of Conduct adopted by Fannie Mae and Freddie Mac was abolished.

The FRB took on this task with gusto, and produced a new section of Regulation Z (Section 226.42). The regulation applies equally to appraisals and to valuations used when an appraisal is not required. It includes (i) general prohibitions on coercion or inducement to "mischaracterize" property value; and (ii) specific requirements that separate the appraisal and valuation functions from the "loan production function."

Cont. p 2

APPRAISAL REQUIREMENTS—REG. Z INDEPENDENCE AND INTERAGENCY GUIDANCE (CONT.)

a. Coercion Prohibited.

The regulation specifies several acts that are prohibited as coercive, including:

- conditioning payment of compensation on a particular value for the property;
- implying that future valuation/appraisal work will be conditioned on the valuation of a particular property;
- excluding an appraiser valuation expert from future engagements because of the value arrived at on a particular property; and
- conditioning compensation of an appraiser or valuation expert on consummation of a transaction.

It also lists certain actions that are specifically permitted, including:

- asking an appraiser or valuation expert to consider additional information about the property or comparable properties;
- asking an appraiser or valuation expert to provide further detail, explanation, or substantiation for their conclusion about value;
- asking for correction of errors in an appraisal or valuation report;
- obtaining multiple valuations or appraisals in order to select "the most reliable" one;
- withholding an appraiser or valuation expert's compensation due to breach of contract or "substandard performance"; and
- other actions permitted or required by federal law.

b. Separation of Valuation Function from Loan Production Function.

The most significant aspect of the regulation is its stringent new requirements to separate all aspects of the valuation/ appraisal function from the "loan production function." The regulation defines the loan production function as any "employee, officer, director, department, division, or other unit" of a lender with responsibility for generating or approving dwelling-secured loans. It defines "valuation management functions" to include recruitment, selection, and retention of the person who will perform a valuation, contracting with or employing a person to perform a valuation, management or oversight of the valuation process, including administrative functions such as receiving orders for valuations and receiving the completed valuations and submitting such valuations to the underwriters, and reviewing or verifying valuations. It accomplishes this separation of functions by creating a general prohibition on conflicts of interest, then creating safe harbor rules for compliance.

i. Safe Harbor - $250,000,000 or Less in Assets. For creditors with assets of $250,000,000 or less as of December 31st for either of the most two recent years, the safe harbor rules are fairly simple. The creditor is deemed to be in compliance as long as: (1) the compensation of anyone preparing a valuation or performing valuation management functions is not based on the value determined in any valuation or appraisal; and (2) the creditor prohibits any employee, officer, director, etc. that orders, performs, or reviews a valuation or appraisal from participating in the loan approval process for that transaction. Thus, for example, a credit union in this category with two loan officers may satisfy the independence requirement if one of the loan officers always orders and reviews valuations or appraisals for transactions that will be approved or denied by the other loan officer.

ii. Safe Harbor - Creditors Over $250,000,000. For creditors over $250,000,000, the safe harbor requirement is more stringent. Persons who either prepare valuations or perform valuation management functions will not be deemed to have a conflict of interest simply because they are employed by the lender or an affiliate of the lender, if the following requirements are satisfied:

Cont. p 3

APPRAISAL REQUIREMENTS—REG. Z INDEPENDENCE AND INTERAGENCY GUIDANCE (CONT.)

- the person's compensation for preparing a valuation or performing valuation management functions is not based on the value of the property; and

- the person who prepares a valuation or performs valuation management functions reports to someone: (a) who is not part of the creditor's loan production function; (b) whose compensation is not based on closing of the transaction for which the valuation is performed; and (c) no one in the loan production function is directly or indirectly involved in selection, retention, or influencing the selection or retention of the person who prepares a valuation or performs valuation management functions.

This leaves credit unions over $250,000,000 in assets with two primary alternatives for compliance: (1) outsource the appraisal management function, including the process of ordering appraisals and the process of reviewing completed appraisals; or (2) adopt policies and practices that carefully delineate which employees are a part of the loan production function, and which employees perform appraisal management functions, and make organizational changes as needed to ensure that employees performing appraisal management functions do not report to employees who are part of the loan production function.

Of course, one drawback of this approach is that it may take employees who are the most experienced and expert at reviewing appraisals and valuations out of the appraisal management function (placing that function into the hands of less experienced employees).

Or, if the credit union wishes to continue having those employees perform valuation management functions, they may have to be reorganized into a different department that does not report to anyone in the loan production function, which may deprive the credit union of their expertise in other lending activities.

The big picture issue is that the agencies believed that lack of such controls contributed in some cases to flawed loans because of the pressure to produce inflated appraisals. Unfortunately, the "cure" (this regulation) may - at least initially - result in appraisals and valuations being reviewed by less qualified employees.

2. INTERAGENCY APPRAISAL GUIDELINES.

In December 2010, the NCUA and the other federal financial institution regulators adopted uniform interagency appraisal and valuation guidelines. These guidelines replaced older guidance that had been issued by a number of the agencies. The interagency guidance deals with a broad range of issues related to appraisals and property valuations, from establishment of and appraisal/ evaluation program, standard for appraisals and appraisers, and for valuations, through appraiser independence, review of appraisers, portfolio monitoring, and use of appraisals or valuations in modifications and workouts. In this article, we discuss the key changes that relate to automated valuation models and appraiser independence guidelines. We will conclude with an overview of the other features of the interagency appraisal guidance.

a. Automated Valuation Models.

The single biggest issue in the interagency appraisal and evaluation guidelines is a "clarification" of the requirements applicable to use of automated valuation models (AVMs) in transactions that do not require an appraisal. The guidance specifies that it is not acceptable for credit unions to use a valuation based on an assumption that the subject property is in "average" or some similar condition. Instead, credit unions must establish policies specifying the extent of research or inspection necessary to determine the property's actual physical condition, and its impact on the valuation.

Most AVMs have relied on just such an assumption - that the property is in "average condition." Because AVMs are based on available data, including tax assessed value, sale prices of comparable homes, and market trends, the physical condition of a property is generally not factored into the value produced by an AVM.

Does this mean that credit unions may no longer use AVMs for transactions that do not require an appraisal? The guidelines still permit use of an AVM as part of the evaluation process. However, a credit union must have some procedure for assessing a property's current physical condition and the impact of physical condition on the property value. This could be as simple as a drive-by assessment by a credit union employee or contractor, or as elaborate as an onsite review by a licensed appraiser. Some companies that provide AVMs are beginning to offer - for an additional fee - property condition assessments as a supplemental service.

Cont. p 4

APPRAISAL REQUIREMENTS—REG. Z INDEPENDENCE AND INTERAGENCY GUIDANCE (CONT.)

b. Other Requirements.

In addition to the requirements for the use of AVMs, the interagency guidance includes a number of other requirements applicable to the use of appraisals and valuations. Here is a brief summary of key portions of the other requirements:

i. Policies and Procedures (Program). Each credit union must maintain an appraisal and evaluation program consistent with the size and scope of its real estate lending operations. The appraisal and valuation program must be reviewed periodically, and must contain the following elements:

- Provide for the independence of the persons ordering, performing, and reviewing appraisals or evaluations.
- Establish selection criteria and procedures to evaluate and monitor the ongoing performance of appraisers and persons who perform evaluations.
- Ensure that appraisals comply with the agencies' appraisal regulations and are consistent with supervisory guidance.
- Ensure that appraisals and evaluations contain sufficient information to support the credit decision.
- Maintain criteria for the content and appropriate use of evaluations consistent with safe and sound banking practices.
- Provide for the receipt and review of the appraisal or evaluation report in a timely manner to facilitate the credit decision.
- Develop criteria to assess whether an existing appraisal or evaluation may be used to support a subsequent transaction.
- Implement internal controls that promote compliance with these program standards, including those related to monitoring third party arrangements.
- Establish criteria for monitoring collateral values.
    - To understand and manage portfolio risk.
    - To address individual loans.
- Establish criteria for obtaining appraisals or evaluations for transactions that are not otherwise covered by the appraisal requirements of the Agencies' appraisal regulations.

ii. Review of Appraisals. The guidelines include a fair amount of detail regarding review of appraisals and evaluations. The guidance indicates that before a final credit decision, as "part of the credit approval process," credit unions must review appraisals and valuations to verify that they comply with applicable regulations and are consistent with supervisory guidance and the credit union's policies. This is one place in which the interagency guidance seems to conflict somewhat with the new Regulation Z provision on appraiser independence. Under the Regulation Z rule, anyone performing a "valuation management function," including reviewing an appraisal or valuation, cannot report to someone who is in the "loan production function" (at least for credit unions over $250,000,000 in assets). It would appear that in reality, the independence requirement trumps this statement in the guidance that review of appraisals and valuations is "part of the credit approval process." With that said, the guidance goes on to require credit unions to establish qualifications for persons who review appraisals and valuations. It also requires credit unions to establish risk based practices for determining the scope of review necessary to ensure that appraisals and valuations are adequate to support the credit decision. In addition, the credit union must adequately document the review process for its appraisals and valuations in each case.

iii. Modifications. The guidance includes direction for when loan modifications may require a new valuation or appraisal or a modification involves only limited changes in the loan terms and does not adversely affect the credit union's collateral protection, no new appraisal or valuation is necessary. However, the agencies caution that, in such cases, the credit union should still have a "understanding of its collateral risk." In modification or workout scenarios involving more substantial changes to loan terms, the credit union's policies and procedures should address the need for current valuation information in order to support the workout arrangements.

The guidance indicates that if a workout does not include advancement of new funds other than reasonable closing costs, the credit union may obtain a valuation rather than an appraisal. If new funds are advanced, the credit union may obtain a valuation instead of an appraisal if there has been no obvious and material change in market conditions and no change in the physical condition of the property that threatens the credit union's interest.

Cont. p 5

APPRAISAL REQUIREMENTS (CONT.)

Credit unions should review the new interagency guidance and Regulation Z change regarding appraisals and valuations carefully, and should update policies and procedures in order to be sure of compliance.

We have worked closely with many of our credit union clients on preparing and implementing comprehensive appraisal program policies. Please contact us if we can assist your credit union in preparing or reviewing appraisal policies that will help your credit union comply with these new regulations.

Hal Scoggins

LOAN ORIGINATOR COMPENSATION—THE NEW REGIME

Nearly a year before the passage of Dodd-Frank, the Federal Reserve Board (FRB) had already initiated a rulemaking designed to severely restrict the ability of lenders to pay incentives (such as yield spread premiums) to loan originators for loans with higher rates or fees. In August 2009, the FRB issued a proposed rule on loan originator compensation. After reviewing more than 6,000 comments on the proposed rule, the FRB issued its final rule in September 2010, with an effective date of April 1, 2010. In the intervening months, lenders, brokers, and other industry participants have struggled to understand and apply some of the nuances and unanswered questions about applying the rule. The FRB has provided some informal interpretation and responses, but has offered little in the way of official – and reliable – clarification.

Who Does the Rule Cover?

The Loan Originator (LO) Compensation rule covers compensation payable to (and prohibits "steering" by) any "loan originator." For the purpose of this rule, a "Loan originator" includes anyone who, for compensation or gain, makes, arranges, or negotiates a loan for a borrower. This includes three primary groups:

- Individual employees of the creditor who originate loans for that creditor;
- A mortgage broker company that brokers loans to lenders; and
- Individual employees of a mortgage broker company who originate loans on behalf of the broker company.

LOAN ORIGINATOR COMP (CONT.)

Thus, the term would apply to employees of a credit union (i.e. loan officers) who originate loans for the credit union. It would apply to a credit union when the credit union acts as a broker for loans made by a different mortgage lender. Finally, it would also apply to individual employees of the credit union when the credit union acts as a broker. In other words, when the credit union acts as a broker, there are two loan originators: the credit union itself, and the credit union employee(s) who perform the origination services. This has significant consequences for compensation of the individual originator, for reasons discussed below. Also, note that the rule applies not only to first mortgages, but to any transaction secured by a dwelling. Thus, the rule impacts compensation payable to its loan officers that originate home equity loans or lines of credit.

Summary of Restrictions

The LO Compensation rule includes four basic restrictions:

- No loan originator's compensation can be based in whole or in part on any term of a loan except the loan amount.
- A loan originator may receive compensation from the borrower or from sources other than the borrower (i.e. the lender), but not from both.
- If the borrower pays a loan originator (i.e. broker company) for a transaction, no other originator may receive compensation "in connection with the transaction" from anyone other than the borrower.
- A loan originator may not "steer" a borrower to a particular loan transaction based on the fact that the originator will receive more compensation from one transaction than from another.

These restrictions seem straightforward, but applying them to real-world situations can be tricky. In the remainder of this article, we provide an overview of each of these restrictions.

No Term-Based Compensation

The primary focus of the prohibition on term-based compensation is to eliminate the formerly prevalent practice of paying yield spread premiums to brokers. (Remember, for the purposes of this rule, a credit union is treated as a loan originator if it acts as a broker to another lender.)

Cont. p 6

LOAN ORIGINATOR COMPENSATION—THE NEW REGIME (CONT.)

A yield spread premium is a payment from the lender to the broker for obtaining a rate that is higher than the lender's benchmark or base rate for the loan in question. For example, a lender might pay base compensation of 1.00% of the loan amount, but would pay an additional 0.25% for each increment of 0.125% by which the loan rate exceeds the base rate. Thus, if the base rate is 4.50%, the compensation for a loan of 4.75% would be 1.50% of the loan amount.

This practice is no longer permitted under the new regulation. A lender may pay a loan originator a flat fee, or a percentage of the loan amount, but may not vary the fee or the percentage based on any other loan terms such as the interest rate or the amount of borrower-paid loan fees. The FRB has indicated the lenders may pay differing rates of compensation for different loan types (i.e. FHA vs. conventional), but only if there is a difference in the amount of work involved in the loan origination that justifies the different compensation. Similarly, lenders may pay "stepped" compensation to an originator where the compensation rate is higher based on higher origination volumes.

The FRB cautions lenders against creating compensation arrangements in which the amount of compensation to an originator varies based on a factor that is a "proxy" for loan terms. In initial informal guidance, the FRB indicated that lenders could not pay different compensation for refinance loans than for purchase money loans, because that could just be a disguised method of paying higher compensation for higher rates. Although it did not acknowledge how silly that position was (can you really steer someone who wants a purchase-money loan into a refinance?), the FRB has since backed away from it.

One thing that the FRB has not backed away from is the idea the new rule prohibits loan originators from granting concessions to borrowers by reducing their compensation, even if the concession is to correct an originator error. For example, if a loan originator underdiscloses a borrower-paid fee on the GFE, and the lender must pay the difference in order to cure a tolerance violation, the lender – not the loan originator – must bear the cost of cure. Lenders may adjust the rate of compensation payable to originators in the long term to account for the originator's error rate, but may not do so on a loan-by-loan basis. That would violate the prohibition on compensation based on loan terms.

No Dual-Source Compensation

The second key component of the compensation rule requires originators to choose between lender-paid compensation and borrower-paid compensation. The rule provides that if the loan originator receives compensation from the borrower, then it may not also receive compensation from any other source, including the lender. Thus, if an originator wants to be paid 1.50% of the loan transaction amount, all of that 1.50% must come from the borrower, or all of it must come from the lender. Collecting 1.00% from the borrower and 0.50% from the lender is no longer permitted.

This prohibition (in combination with the third prohibition discussed below) has greatly affected how lenders and originators price their loan offerings. In some settings, lender-paid compensation is preferable, but in order for the lender to pay the compensation to the originator, the lender will require higher compensation (usually in the form of a higher interest rate). For example, a lender might offer a loan with borrower-paid compensation (borrower pays an origination fee of 1.00%) at 4.75%, but the same loan with lender-paid compensation (the same 1.00% origination fee) would cost the borrower 5.00%. It is permissible for an originator to offer borrowers such a choice as long as the originator's fee is no more under the lender-paid model than it is under the borrower-paid model.

Loan Originator Employees May Not Receive Transaction-Based Compensation Under Borrower-Paid Model

One of the most significant features of the new rule is not actually explicitly stated in the rule. Section 226.36(d)(2) states: "If any loan originator receives compensation directly from a consumer in a consumer credit transaction secured by a dwelling: (i) No loan originator shall receive compensation, directly or indirectly, from any person other than the consumer in connection with the transaction . . ." This has been interpreted to mean that in a transaction where a company is originating a loan for the lender, and the borrower is paying the origination fee to the originator company, the originator company cannot pay transaction-based compensation to its loan officer (who is also an originator). Thus, where a credit union is acting as a broker for another lender, and the borrower pays the credit union's origination fee, the credit union may not pay a portion of that fee to its loan officer.

Cont. p 7

LOAN ORIGINATOR COMPENSATION—THE NEW REGIME (CONT.)

Rather, the credit union may only pay a regular salary that is not dependent on closing of the loan or on the amount of the loan. In fact, the FRB has indicated that the credit union may not even provide profit-sharing or profit-based compensation to the loan officer, because profit is attributable to loan closings and is therefore considered "transaction-based."

Note that this prohibition only applies in the borrower-paid compensation setting. If the lender pays the origination fee to the credit union, the credit union is free to pay a percentage of that fee (or of the loan amount) to its loan officer. This makes the lender-paid compensation model highly attractive for broker companies, because it allows them to compensate loan originators as they traditionally have – with incentives for production. On the other hand, it seems that loans with lender-paid compensation are generally more expensive than loans with borrower-paid compensation, even though there is no difference (from the borrower's perspective) in product.

This does not affect credit unions or other lenders that only originate loans that they make and fund in their own name. But it has created serious turmoil in loan officer compensation arrangements for credit unions that broker mortgage loans other lenders. Such credit unions must choose between: (a) offering only loans with lender-paid compensation; and (b) offering borrower-paid compensation, but only paying straight salary (or hourly) wages to loan officers that originate loans with borrower-paid compensation.

Anti-Steering Rules

Finally, the new rule prohibits loan originators from "steering" borrowers to a particular loan based on the fact that the originator will receive higher compensation from that loan than for other loans that could have been offered to the borrower. The rule creates a safe harbor to demonstrate compliance. The safe harbor requires the originator to: (i) obtain loan options from a "significant number" of creditors that the originator regularly deals with; and (ii) provide the borrower with options for the type of loan the borrower has requested that include: (a) the loan with the lowest interest rate; (b) the loan with the lowest interest rate that does not include negative amortization, prepayment penalty, interest-only payments, a balloon payment in the first seven years of the loan, a demand feature, shared equity, or shared appreciation percentage; and (c) the loan with the lowest total origination points and fees.

For purposes of this rule, the "type" of loan requested by the borrower refers to whether the loan has a fixed or variable rate, or is a reverse mortgage. The same loan option may satisfy both of the first two requirements; thus, a creditor might be able to satisfy the safe harbor requirement by providing as few as two options. The originator must have a good faith belief that the borrower meets the requirements for each option presented to the borrower.

If a credit union's (or loan officer's) compensation is the same for all loans it originates (i.e. if the credit union will always receive a flat 1.00% origination fee), then the credit union may ignore the safe harbor requirements, because it would be impossible for the credit union to steer a member to a particular loan based on compensation to the credit union.

All credit unions making or brokering dwelling-secured loans should check their policies and practices on: (a) compensation to loan officers originating dwelling-secured loans; and (b) compensation to the credit union when the credit union originates a loan for another lender. Credit unions should document their approach to compliance with the new restrictions so that the regulator (or other interested parties) can verify compliance.

We have worked with a number of clients to determine the best approach for compliance with the new loan originator compensation restrictions in their specific circumstances. Please call Hal Scoggins or Brian Witt if you would like us to assist you on this issue.

Hal Scoggins

MDIA DISCLOSURE REVISIONS—ODDS AND ENDS

On January 31, 2011, lenders were required to begin using the new "Interest Rate and Payment Summary" that the Federal Reserve Board (FRB) adopted to comply with requirements of the Mortgage Disclosure Improvement Act (MDIA). As with any major regulatory change, the FRB did not anticipate or provide instructions to lenders on how the new disclosure rules apply to certain types of loan products or features. While we may get clarification from the FRB on some of these issues in the future, this article explores some of the most common problems that have arisen and how credit unions can deal with them until the FRB provides more formal guidance.

Cont. p 8

MDIA DISCLOSURE REVISIONS—ODDS AND ENDS (CONT.)

The MDIA revisions required lenders to replace the old "payment schedule" disclosures with a new "interest rate and payment summary" for all dwelling-secured loans. The "payment schedule" disclosed the timing and amount of each anticipated payment stream under the loan (i.e. 120 payments of $659.87 due monthly, beginning July 1, 2011), based on the terms and conditions in effect at closing. The new interest rate and payment summary provides "worst case scenario" estimates of payments on the loan at specified times. For variable rate loans, the lender must disclose the initial rate and payments, the highest possible rate and payments during the first five years, and the highest possible rate and payments over the term of the loan. For interest-only loans in which the interest-only period will expire before the first rate adjustment, an additional column would be added to show the rate and payments in effect when the interest-only period ends.

In spite of the regulation's commentary on how the disclosures should be completed in various situations, there are some fairly common scenarios that the new MDIA regulations simply don't address.

Preferred Rate Loans

Many credit unions offer a "preferred-rate" loan in which there is a rate discount that can be revoked on occurrence of a specific event, such as discontinuation of auto-pay or termination of employment with the credit union. Although these are considered variable rate transactions, there is no specific timeframe for rate adjustments, and in fact the credit union presumably hopes that the rate will never be adjusted because the triggering event will not occur.

Lacking any guidance from the FRB on this issue, we believe that the best approach is to disclose based on the worst-case scenario. This means that the credit union would calculate figures based on the assumption that the discount is essentially revoked immediately after the first payment. This would result in a disclosure of initial rate and payment amount that includes the discount. To calculate the maximum in the first five years, the credit union would assume that the discount is revoked immediately after the first payment. For fixed rate loans, the "maximum ever" rate and payment would be the same as the maximum during the first five years. For variable rate loans, the "maximum during first five years" would include the assumption that the discount was revoked immediately. That same assumption would remain in effect for the "maximum ever" column.

Construction/Permanent Loans With Interest-Only During Construction

Construction/Permanent loans have always been a bit of a disclosure oddity; lenders can choose to disclose the construction and permanent periods separately or together. When making a combined disclosure, the previous rules indicated that interest-only payments during the construction period are not disclosed in the payment schedule. The initial MDIA regulation did not address how this issue would be handled in the "Interest Rate and Payment Summary." The December clarification indicates that the same treatment apparently carries through under the new format. Thus, if the credit union provides combined TILA disclosures for the construction and permanent phases, the interest rate and payment summary will only disclose information for the permanent phase of the loan. The interest only payments during the draw period should be disclosed underneath the interest rate and payment summary with a reference such as "Interest-only payments are due monthly during the draw period." On the other hand, if the construction and permanent phases are disclosed separately, then the construction disclosure would include figures for the interest-only payments in the interest rate and payment summary.

Initial Rate is Discounted by More than Annual Cap

The new requirements include a special disclosure beneath the interest rate and payment summary when the loan has a discounted initial rate. That disclosure reads: "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 _____%." The official staff comment to Section 226.18(s)(2)(iii)(B) indicates that the "place in sequence" refers to the month or year of the rate change resulting from expiration of the initial rate.

However, when the initial rate is discounted by an amount greater than the annual rate cap, it may take more than one rate adjustment for the rate to rise to the fully indexed rate. The FRB did not provide direction on this issue. The most straightforward reading of the regulation and official comments is that the "period in sequence" and the rate applicable to that period are the expiration of the initial rate, even though a rate cap would still keep the rate below the fully indexed rate in effect at the time the loan was made.

Cont. p 9

MDIA DISCLOSURE (CONT.)

For example, assume that the index at closing is 3.25%, and the margin for the loan is 3.00, but the initial rate is discounted to 5.00%, with a 1% annual cap. The loan is a 1 year ARM. The disclosure would read: "You have a discounted introductory rate of 5.00% that ends after 12 months. In the thirteenth month, even if market rates do not change, this rate will increase to 6.00%."

That disclosure is accurate, but incomplete, because the fully indexed rate is actually 6.25%. The regulation as currently written does not offer any guidance or any method to let the member know that after the first increase, there will be a second (unless the index rate goes down). It would be nice to get some further clarity on this from the FRB, but until we have such clarity, the approach illustrated above is the most compliant.

Harmonizing the Promissory Note and TIL Disclosure

In revising loan disclosures to comply with the new MDIA regulations, it is important to be sure that your documents retain their completeness and cohesion. There are many forms of promissory notes and disclosures, and the new requirements affect different documents in different ways. Some credit unions use a separate promissory note and TIL disclosure; others use a combined form that serves both purposes. If your promissory note includes references to the payment schedule in the TIL disclosures (i.e. "your payments will be due as reflected in the payment schedule"), you may need to change those references because the payment schedule has disappeared.

If you would like us to review your promissory note and TIL disclosures to assure compliance and contractual integrity, please contact Hal Scoggins or Jeff Martin.

Hal Scoggins

"KNOW BEFORE YOU OWE" THE CFPB LAUNCHES ITS PROCESS TO SIMPLIFY REAL ESTATE LOAN DISCLOSURES

The old stereotype about slow-moving government bureaucracies doesn't seem to apply to the Consumer Financial Protection Bureau (CFPB). With the designated transfer date for most CFPB duties and powers still two months away, the CFPB has launched its initiative to combine the current Good Faith Estimate

REAL ESTATE DISCLOSURES (CONT.)

form (prescribed by HUD under RESPA) and TIL estimate (prescribed by the Federal Reserve Board under TILA).

HUD attempted to take create a combined disclosure of loan terms and settlement costs when it issued the new GFE and HUD1 forms that became mandatory last year. However, HUD had no authority to revise the TIL forms mandated by the FRB. The CFPB has that authority and is moving quickly to use it. Dodd-Frank requires the CFPB to issue a proposed form by July 21, 2012. CFPB has taken a first step in that direction with the issuance of draft forms. Unlike some rulemaking actions where the first anyone sees of the draft forms is when the proposed regulation is issued, CFPB plans a long "incubation" period for the forms before they ever formally proposed.

The CFPB has issued two draft versions of a mortgage disclosure form and has asked for industry and consumer feedback on the two approaches. The CFPB is not actually proposing the new forms yet. Instead, the agency is soliciting feedback on the forms before issuing any formal proposal. It will conduct five rounds of consumer testing in several cities, and will revise the draft forms based on the feedback it receives. After the testing and revision process has been completed, the CFPB will then issue a proposed regulation for the new form. There will be a comment period on the proposed regulation, then the CFPB will make any further adjustments based on the comments before issuing a final regulation.

One thing that the CFPB did not address is the treatment of final disclosures (final TIL and HUD1). Dodd-Frank did not distinguish between the early and final TIL disclosure in its mandate to combine the TIL and RESPA forms. However, the draft forms are clearly intended only for use at application, and not at closing. The CFPB has not given any indication what it will do about final disclosures. To view the drafts, click on the following link: http://www.consumerfinance.gov/knowbeforeyouowe/

The proposed forms attempt to highlight key loan terms on one page, with key closing cost items on the second page. These forms are truly simplified – there will be many questions to answer and revisions to make as the development process continues.

It will be interesting to see whether the CFPB can keep the disclosures limited to two pages, and if so whether the information will really provide that much benefit to consumers. Stay tuned.

Hal Scoggins

Overwhelmed by the Weight of Compliance?

If you are looking for solutions to better manage your credit union's compliance, without adding more staff, Farleigh Wada Witt has exciting news: a new compliance management system for credit unions. Call or email Brian Witt or Hal Scoggins for more information. We stand behind our credit union clients' compliance!

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Farleigh Wada Witt—One of Oregon's 100 Best Companies to Work For, Oregon Business Magazine

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