

CONSUMER COMPLIANCE OUTLOOK®

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A FEDERAL RESERVE SYSTEM
PUBLICATION WITH A
FOCUS ON CONSUMER
COMPLIANCE ISSUES

THE BANK DIRECTOR'S ROLE IN ESTABLISHING A "CULTURE OF COMPLIANCE"

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This article provides insights into a bank director's role in fostering an effective compliance culture and provides a basic model that can be applied in a proactive compliance risk management program.

THE ROLE OF THE DIRECTOR IN ENSURING CONSUMER COMPLIANCE

The hallmark of the Federal Reserve System's approach to consumer compliance supervision is its emphasis on ensuring that appropriate risk management controls are in place and consumers' rights are protected. As Federal Reserve Governor Elizabeth Duke recently stated before Congress:

*"One objective of our consumer compliance examination program is to identify compliance risks at banks before they harm consumers and ensure that state member banks have appropriate controls in place to manage those risks. In conducting a consumer compliance examination at a state member bank, examiners review the commitment and ability of bank management to comply with consumer protection laws as well as the bank's actual compliance with such laws."*¹

One of the most important components of this approach is the board of directors' oversight of the bank's compliance risk management program. In addition to establishing expectations for the institution, the board must first understand the nature of the risks significant to the institution and sufficiently empower senior management to measure, monitor, and control these risks. The level and scope of such activities vary with the size and complexity of the organization. However, the concept is the same. Organizations with the most effective compliance management programs do not layer consumer compliance over operations, but instead imbed the concept of consumer compliance *within* daily operations. In other words, they have a "culture of compliance."

In a previous issue of *Consumer Compliance Outlook*, Phyllis Harwell from

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¹ Governor Elizabeth A. Duke, "Federal and State Enforcement of Financial Consumer and Investor Protection Laws," hearing before the House Financial Services Committee, 111th Congress, March 20, 2009. Available at: http://www.house.gov/apps/list/hearing/financialsvcs_dem/press0320093.shtml

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AN OVERVIEW OF THE HOME AFFORDABLE MODIFICATION PROGRAM

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On February 18, 2009, President Obama announced the creation of the Homeowner Affordability and Stability Plan (HASP) to help millions of struggling homeowners avoid foreclosure by refinancing or modifying their first mortgages.¹ This plan has two primary components: 1) the Home Affordable Refinance Program (HARP), to help borrowers refinance distressed mortgage loans into new loans with lower rates; and (2) the Home Affordable Modification Program (HAMP), to help homeowners at "imminent risk of default" on their mortgages by modifying their loans. In the current economic environment, banks and servicers may find it beneficial to understand the HAMP program.

HOW DID WE GET HERE?

Before discussing HAMP's features, it is helpful to review the government loan modification programs preceding it because many of its features reflect lessons learned from the previous programs.

Streamlined Foreclosure and Loss Avoidance Framework

Servicers play many roles in the mortgage process, but their primary responsibility is to collect payments from homeowners and remit payments to investors. When the homeowner is delinquent, servicers have a fiduciary responsibility to initiate loss mitigation practices that are in the best interest of investors but within the framework established under their pooling and servicing agreements. Because over 70 percent of all residential mortgages are managed by servicers and owned by investors, one of the first government programs to address foreclosures focused on delinquent mortgages held in securitized trusts.

On December 6, 2007, Treasury Secretary Paulson announced a plan to reduce the number of delinquencies and foreclosures among adjustable rate subprime homeowners whose mortgages had been securitized.² Under the Streamlined Foreclosure and Loss Avoidance Framework, better known as the "Teaser Freezer" plan, mortgage servicers would be encouraged to initiate communication with subprime borrowers and to voluntarily modify their mortgages. Specifically, servicers were encouraged to modify mortgages by freezing the homeowner's introductory interest rate for five years.

¹ The Treasury Department, which administers the program, published an overview of HASP in a news release available at <http://www.treas.gov/press/releases/tg33.htm>.

² The plan is formally known as the "American Securitization Forum Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime Adjustable Rate Mortgage Loans." <http://www.americansecuritization.com/uploadedFiles/ASFStreamlinedFrameworkQA121707.pdf>

Eligibility for the plan was limited to a sub-group of homeowners who acquired their homes using an adjustable rate subprime loan product. Other requirements were that homeowners had to be in relatively good standing on their mortgage and were not able to refinance into a fixed rate or government-insured product. It was also necessary that the mortgage cover an owner-occupied property held in a securitized pool.

The pooling and servicing agreements presented a major obstacle to modifying mortgages. In most cases, servicers are restricted from modifying mortgages without investor approval, and obtaining investor approval can be a challenge for the servicer.

Federal Deposit Insurance Corporation's (FDIC) Loan Modification Program, or "Mod in a Box"

Loan modifications are difficult to implement when the mortgage has been securitized and is being held by investors. But what if the primary owner of a pool of mortgages is a government entity such as the FDIC? After the failure of IndyMac Federal Savings Bank, the FDIC assumed control and initiated a modifica-

THE FDIC LOAN MODIFICATION PROGRAM, OR "MOD IN A BOX," ATTEMPTS TO REDUCE THE HOMEOWNER'S FRONT-END DEBT-TO-INCOME RATIO (DTI) USING A STANDARDIZED MODIFICATION PROCESS.

tion program for mortgages securitized or serviced by IndyMac. The requirements for eligibility are that homeowners must be at least 60 days delinquent on their primary mortgage and must have a cumulative loan-to-value (CLTV) ratio greater than 75 percent.

The FDIC Loan Modification Program, or "Mod in a Box," attempts to reduce the homeowner's front-end debt-to-income ratio (DTI)³ using a standardized modification process.⁴ This process uses a net present value (NPV) tool to evaluate the merits of modifying each delinquent mortgage relative to foreclosure. If modifying a mortgage yields a positive NPV, the program mandates that a modification be initiated. Under the program, the following sequential steps are taken to modify a mortgage:

- 1. Interest Rate Reduction:** To reduce the homeowner's front-end DTI ratio to 38 percent, the servicer can reduce the interest rate on the mortgage, but the interest rate cannot fall below a floor of 3 percent.⁵
- 2. Extended Amortization Term:** If the homeowner's front-end DTI ratio still exceeds 38 percent after the interest rate on the mortgage has been adjusted, the mortgage will be amortized out to a maximum of 40 years, with a term no greater than 30 years.
- 3. Partial Payment Forebearance:** If the homeowner's front-end DTI ratio still exceeds 38 percent, the last option is to split the debt into an interest-bearing, amortizing portion and a zero percent, zero payment portion of the loan. The repayment of the "postponed" principal will be due when the loan is paid in full.

One problem that "Mod in a Box" and other earlier programs encountered is the decline in house values. Lenders and servicers are unlikely to modify mortgages

if they believe homeowners are likely to re-default. Declining house prices increase the risk of re-default because some borrowers are reluctant to continue making mortgage payments when their house value is declining, especially if they are "under water"; that

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³ Front-end DTI refers to the ratio of a borrower's monthly housing-related expenses (mortgage, real estate taxes, insurance, etc.) divided by the borrower's gross monthly income. Back-end DTI refers to total monthly debt (housing payments plus all recurring monthly non-housing-related debt payments) divided by the borrower's monthly gross income.

⁴ The FDIC's website provides more details about the "Mod in a Box" program: <http://www.fdic.gov/consumers/loans/loanmod/loanmodguide.html>.

⁵ The modified interest rate remains in effect for five years but will increase at a rate of no more than 1 percent a year until the Freddie Mac Weekly Survey Rate has been achieved. If the modified interest rate is set below the prevailing market interest rate for mortgages of similar term, the modified interest rate will gradually increase after five years to either the original interest rate or the market interest rate at the time of the modification.

MORTGAGE DISCLOSURE IMPROVEMENT ACT OF 2008 - AMENDMENTS TO REGULATION Z

The Second Quarter issue of *Consumer Compliance Outlook* promoted a “Call the Fed” audio conference on Consumer Compliance Hot Topics hosted by the Federal Reserve Bank of San Francisco. We have received a significant number of follow-up questions, the majority of which were about the Mortgage Disclosure Improvement Act (MDIA) rules. As a result, we have developed an MDIA summary followed by a series of questions and answers. In particular, we hope to provide additional clarification to questions that generated the most significant discussion on the call.

GENERAL INFORMATION

Applicability

The MDIA became effective on July 30, 2009. On May 19, 2009, the Federal Reserve Board published final amendments to Regulation Z to implement the MDIA. The MDIA and the amendments apply to any closed-end consumer mortgage transaction subject to the Real Estate Settlement Procedures Act (RESPA) that is secured by a consumer’s dwelling. That includes home refinance and home equity loans but does not include loans that are not “consumer credit,” which is not subject to disclosure under Regulation Z. Existing guidance in comment 3(a)-2 of the Official Staff Commentary (OSC) for Regulation Z provides factors for determining whether an extension of credit is primarily for business or commercial purposes (rather than consumer credit).

Business Day Definitions

- General definition: days on which the creditor’s offices are open to the public for carrying on substantially all of its business functions. Applies to the period of three business days for providing early disclosures (creditors must provide early disclosures within three business days after they receive the consumer’s application).
- More precise definition: all days except Sundays and specified legal holidays. This definition applies for the purposes of calculating the seven-business-day waiting period or the three-business-day waiting period before consummation may occur if corrected disclosures are required. This definition also

applies to the presumption that mailed disclosures are received three business days after mailing. This definition is also used for rescission purposes.

Timing Rules

- A creditor must deliver or mail the early disclosures for all dwelling-secured mortgage loans subject to RESPA no later than three business days (general definition) after the creditor receives a consumer’s application.
- A creditor must also deliver or place in the mail the early disclosures no later than seven business days (more precise definition) before consummation. The seven days do not run from the date when the consumer receives or is deemed to receive the early disclosures, but rather from the date when the early disclosures are mailed or delivered in person.
- If corrected disclosures are required, consummation may not occur until three business days (more precise definition) after the consumer receives the corrected disclosures. If a creditor places corrected disclosures in the mail, the consumer is deemed to receive them three business days after they are mailed (more precise definition).
- A creditor may not impose a fee (other than for obtaining a consumer’s credit history) before the consumer receives the early disclosures. If a creditor places early disclosures in the mail, the consumer is deemed to receive them three business days after they are mailed (more precise definition).
- Under §226.17(d), if there are multiple consumers primarily liable on a consumer credit transaction, Truth in Lending Act (TILA) disclosures need only be given to one of those consumers. If the extension of credit is a rescindable mortgage transaction, however, TILA disclosures must also be provided to each consumer whose ownership interest is subject to the security interest and has a right to rescind the transaction (including a consumer who is not a borrower).

QUESTIONS AND ANSWERS

1. **Section 226.19(a)(4) requires the following statement be included on the early disclosure: “You are not required to complete this agreement merely because you have received these disclosures or completed a loan application.” Where should the statement be included on the disclosures?**

Under §226.19(a)(4), this statement must be grouped together with the disclosures required by §226.18, but it need not be grouped together with the disclosures that are required to be “more conspicuous.” If the §226.18 disclosures are grouped together and bordered by a box, the notice must appear in the box. However, comment 17(a)(1)-2 of the OSC clarifies that those disclo-

THE IMMINENT SALE OF THE CONSUMER’S HOME AT FORECLOSURE, WHERE THE FORECLOSURE SALE WILL TAKE PLACE UNLESS LOAN PROCEEDS ARE MADE AVAILABLE TO THE CONSUMER DURING THE WAITING PERIOD, IS ONE EXAMPLE OF A BONA FIDE PERSONAL FINANCIAL EMERGENCY.

ures may be grouped together and segregated from other information in other ways, such as by bold dividing lines, a different color background, or a different type style.

If a creditor must make corrected disclosures, the creditor may provide either all the disclosures required by §226.18 (as applicable) or only the terms that vary from those previously disclosed, as provided in comment 19(a)(2)(ii)-2 of the OSC. Whichever disclosures the creditor chooses to make, the statement required by §226.19(a)(4) must be provided and must be grouped together with those disclosures. Again, those disclosures may, but need not, be segregated by being enclosed in a box, but they must be segregated by some means.

2. **What constitutes a “bona fide personal financial emergency”?**

Under the MDIA, a consumer may modify or waive the seven-day or three-day waiting period before consummation if the consumer has a bona fide personal financial emergency that necessitates consummating the credit transaction before the end of the waiting period. Whether these conditions are met is determined by the facts surrounding individual situations. However, the consumer must receive accurate TILA disclosures at or before the time the consumer modifies or waives the waiting period.

To modify or waive a waiting period, the consumer must give the creditor a dated written statement that describes the emergency, specifically modifies or waives the waiting period, and bears the signature of all the consumers who are primarily liable on the legal obligation. Creditors may not use pre-printed forms for this purpose.

The imminent sale of the consumer’s home at foreclosure, where the foreclosure sale will take place unless loan proceeds are made available to the consumer during the waiting period, is one example of a bona fide personal financial emergency. See comment 19(a)(3)-1 of the OSC. However, there may be additional situations that constitute bona fide personal financial emergencies. Institutions should make the decision as to whether a bona fide personal financial emergency exists on a case-by-case basis.

3. **When sending corrected disclosures by e-mail or courier, can we presume receipt on the third business day without documenting actual delivery?**

Yes, just as with standard mail, the creditor may presume that the consumer receives the corrected

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ON THE DOCKET: RECENT FEDERAL COURT OPINIONS*

REGULATION Z - TRUTH IN LENDING ACT (TILA)

Court rules on “clear and conspicuous” disclosure standard. *Barrer v. Chase Bank USA, N.A.* 566 F.3d 883 (9th Cir. 2009). Chase raised the APR on plaintiffs’ credit card account from 8.99 to 24.24 percent. The plaintiffs filed a class action suit alleging that Chase violated the Truth in Lending Act (TILA) and Regulation Z by failing to disclose in the account-opening agreement that, in addition to rate increases imposed for events of default specified in the agreement, Chase could also increase the rate because of adverse information in the consumer’s credit report. In this case, the rate increase was based on credit report information indicating that the cardholder had recently opened a number of other revolving accounts and maintained high balances on those accounts. The district court granted Chase’s motion to dismiss and the plaintiffs filed this appeal. The Ninth Circuit held that, contrary to the plaintiffs’ claim, Chase was not required to disclose its risk-based pricing policies. According to the court, it was sufficient that Chase disclosed that it was reserving the right to change the account terms and increase the rate for any reason without limitation, and that Chase implemented the increase by sending notice of the new rate to the consumer before it became effective. The Ninth Circuit also ruled, however, that the plaintiffs had stated a valid legal claim because, as a matter of law, Chase could not show that the change-in-terms provision in its credit agreement satisfied the “clear and conspicuous” requirement in Regulation Z. The court stated that the change-in-terms provision was “buried too deeply in the fine print” of the agreement for a reasonable cardholder to realize that the provision existed.

Technical TILA violation does not trigger rescission. *Melfi v. WMC Mortgage Corporation*, 568 F.3d 309 (1st Cir. 2009). The First Circuit affirmed the dismissal of a rescission claim based on a technical violation in the creditor’s rescission notice to the borrower. Section 226.23(b)(1)(v) of Regulation Z requires creditors to disclose in the rescission notice the date on which the rescission period expires. The creditor used the Federal Reserve Board’s rescission model form but neglected to fill in the blank spaces for the transaction date and the rescission period expiration date. The creditor stamped the transaction date on the top of the notice but did not designate it as the transaction date. The borrower argued that the loan was subject to rescission because the creditor failed to provide the transaction and rescission expiration dates. The First Circuit rejected this argument, finding that “technical deficiencies do not matter if the borrower receives a notice that effectively gives him notice as to the final date for rescission and has the three full days to act. Our test is whether any reasonable person, in reading the form provided in this case, would so understand it. Here, the omitted dates made no difference.”

FAIR CREDIT REPORTING ACT (FCRA)

Damages and attorney’s fees for failing to correct errors in credit report. *Robinson v. Equifax Information Services, LLC*, 560 F.3d 235 (4th Cir. 2009). The Fourth Circuit affirmed a damage award of \$200,000 against Equifax for numerous violations of the FCRA because it repeatedly failed to correct information in a consumer’s credit report. The plaintiff was a victim of identity theft who contacted Equifax to correct errors in her credit report. Because Equifax repeatedly placed incorrect information in the plaintiff’s credit report for several years, she was unable to obtain credit from 2003 to 2006. The plaintiff spent several hundred hours trying to correct the mistakes and experienced headaches, sleeplessness, and hair loss because of the distress and her inability to obtain credit. The Fourth Circuit affirmed the amount of the damages award based on the plaintiff’s loss of opportunities in the home mortgage market, emotional stress, and loss of income from missing approximately 300 hours of work in order to address Equifax’s errors. However, the court reversed the award of \$268,652.25 in



attorney's fees because the plaintiff failed to offer evidence of the prevailing market rates for attorney's fees. The court remanded the case so that the trial court could receive evidence about market rates and recalculate the amount of awarded attorney's fees accordingly.

REGULATION X – REAL ESTATE SETTLEMENT PROCEDURES ACT (RESPA)

Court rejects RESPA title insurance markup claim. *Hancock v. Chicago Title Ins. Co.*, 2009 U.S. Dist. Lexis 59015 (N.D. Tex. July 9, 2009). This class-action lawsuit alleged that by charging more for a reissue title insurance policy than allowed by Texas law, a title insurer violated §8(b) of RESPA because the excess charges were not for services actually performed. Texas law sets the rate title insurance companies can charge for title insurance and requires discounts for policies for a refinanced mortgage (known as a reissue policy). The insurer did not provide the plaintiffs the discount for their reissue policy and instead split the entire premium with its title agents. Section 8 of RESPA prohibits kickbacks, referral fees, and unearned fees in connection with real estate settlement services. The court determined that the insurer did not violate §8(b) because RESPA is not a price-control statute and does not impose liability for overcharges as long as services are provided. Because it was undisputed that both the title insurer and its agents performed title insurance services, the court dismissed the RESPA §8(b) claim.

PREEMPTION

State officials can enforce nonpreempted state law against national banks. *Cuomo v. Clearing House Association, L.L.C.*, 129 S.Ct. 2710 (2009). The U.S. Supreme Court struck down a preemption regulation of the Office of the Comptroller of the Currency (OCC) that prohibited state officials from enforcing nonpreempted state laws against national banks. The regulation implemented the preemption provision in §484(a) of the National Bank Act (NBA). The New York attorney general (NYAG) began investigating whether national banks were violating New York's fair lending laws, which the NBA does not preempt, after the release of data under the Home Mortgage Disclosure Act in 2005 showing that African-American and Hispanic borrowers had a significantly higher percentage of higher-cost loans than white borrowers. The NYAG sent informal requests to several national banks for loan information in lieu of a formal subpoena. In response, the OCC and the Clearing House Association obtained an injunction in a New York federal district court halting the investigation based on the OCC's preemption regulation, 12 C.F.R. §7.4(a)(2)(iv), which prevents state officials from enforcing state or federal laws against national banks for activities permitted under the NBA. A divided panel of the Second Circuit affirmed the district court's injunction in *Clearing House Association, L.L.C. v. Cuomo*, 510 F.3d 105 (2d Cir. 2007). The Supreme Court reversed, holding that the preemption provision in the NBA is limited to bank supervision and oversight functions by the OCC and does not preempt judicial *enforcement proceedings* by state officials of nonpreempted state law. However, the court imposed an important restriction on state officials: Enforcement can be conducted only through judicial proceedings. This was designed to "prevent 'fishing expeditions' or an undirected rummaging through bank books and records for evidence of some unknown wrongdoing."

* Links to the court opinions are available in the online version of *Outlook* at <http://www.consumercomplianceoutlook.org>.

NEWS FROM WASHINGTON: REGULATORY UPDATES

The Department of Housing and Urban Development (HUD) releases frequently asked questions on new Real Estate Settlement Procedures Act (RESPA) rules.

On August 13, 2009, HUD released frequently asked questions (FAQs) regarding the implementation of the new RESPA rules. The FAQs were compiled from questions received from industry since the publication of the rules on November 17, 2008. The rules are scheduled to take effect on January 1, 2010. The press release and FAQs can be found on HUD's website at <http://www.hud.gov/news/release.cfm?content=pr09-153.cfm>.

The Board of Governors of the Federal Reserve System (Board) proposes significant changes to Regulation Z (Truth in Lending) intended to improve the disclosures consumers receive in connection with closed-end mortgages and home-equity lines of credit.

On July 23, 2009, the Board proposed significant changes to Regulation Z intended to improve the disclosures consumers receive in connection with closed-end mortgages and home-equity lines of credit (HELOCs). These changes, offered for public comment, reflect the result of consumer testing conducted as part of the Board's comprehensive review of the rules for home-secured credit. Closed-end mortgage disclosures would be revised to highlight potentially risky features such as adjustable rates, prepayment penalties, and negative amortization. The rules for HELOCs would be revised to change the timing, content, and format of the disclosures creditors provide to consumers at application and throughout the life of such accounts. The deadline for submitting comments is December 24, 2009. The Board's press release and the *Federal Register* notice can be found at <http://www.federalreserve.gov/newsevents/press/bcreg/20090723a.htm>.

The Federal Deposit Insurance Corporation, Board, National Credit Union Administration, Office of the Comptroller of the Currency, Office of Thrift Supervision (the Agencies), and

the Farm Credit Administration (Administration) release revisions to *Interagency Questions and Answers Regarding Flood Insurance*.


On July 21, 2009, the Agencies and the Administration released the revised *Interagency Questions and Answers Regarding Flood Insurance (2009)*, which supersedes the 1997 interagency questions and answers and supplements other guidance or interpretations issued by the Agencies and the Federal Emergency Management Agency. The Agencies and the Administration are also proposing for public comment five new questions and answers on determining insurable value in calculating the maximum limit of coverage available for the particular type of property and the timing of force placement of required flood insurance by lenders. The comment period ended September 21, 2009. The press release and *Federal Register* notice are available at <http://www.federalreserve.gov/newsevents/press/bcreg/20090721a.htm>.

The Agencies and the Federal Trade Commission (FTC) publish final rules and guidelines to promote accurate reports about consumers.

On July 2, 2009, the Agencies and the FTC published final rules and guidelines to promote the accuracy and integrity of information furnished to credit bureaus and other consumer reporting agencies. The final rules and guidelines are scheduled to take effect July 1, 2010. The federal agencies and the FTC also published an Advance Notice of Proposed Rulemaking to identify possible additions to the information that furnishers must provide to consumer reporting agencies, such as the account opening date. The press release and *Federal Register* notice are available at <http://www.federalreserve.gov/newsevents/press/bcreg/20090702a.htm>.

The Agencies announce proposed revisions to regulations implementing the Community Reinvestment Act (CRA).

On June 24, 2009 the Agencies proposed revisions to regulations implementing the CRA to require the Agencies to consider low-cost education loans provided to low-income borrowers when assessing a finan-



cial institution's record of meeting community credit needs. This proposal incorporates provisions of the recently enacted Higher Education Opportunity Act, which revised the CRA. The comment period ended on July 30, 2009. The press release and *Federal Register* notice are available at <http://www.federalreserve.gov/newsevents/press/bcreg/20090624a.htm>.

The Agencies issue FAQs on identity theft rules.

On June 11, 2009, the Agencies issued FAQs to help financial institutions, creditors, users of consumer reports, and issuers of credit and debit cards comply with the "Red Flags and Address Discrepancy Rules," which implement sections of the Fair and Accurate Credit Transactions Act that were issued jointly on November 9, 2007. The Agencies' staffs have jointly developed answers to these FAQs to provide guidance on numerous aspects of the rules. The joint press release can be found at <http://www.federalreserve.gov/newsevents/press/bcreg/20090611a.htm>.

The Agencies release list of distressed or underserved nonmetropolitan middle-income geographies.

On June 8, 2009, the Agencies released the 2009 list of distressed or underserved nonmetropolitan middle-income geographies in which revitalization or stabilization activities will receive CRA consideration as "community development." As with past releases, the 2009 list will incorporate a one-year lag period for geographies designated as distressed or underserved in 2008 but not designated as such in 2009. Geographies subject to this one-year lag period are eligible to receive consideration for community development activities for 12 months after publication of the 2009 list. The 2009 list of distressed or underserved geographies can be found on the FFIEC website <http://www.ffiec.gov/>.

The Agencies and Administration propose rules for the Secure and Fair Enforcement for Mortgage Licensing Act (S.A.F.E. Act).

On June 1, 2009, the Agencies and the Administration issued for public comment proposed rules requiring mortgage loan originators who are employees of

agency-regulated institutions to meet the registration requirements of the S.A.F.E. Act. The S.A.F.E. Act requires the Agencies and the Administration to jointly develop and maintain a system for registering residential mortgage loan originators who are employees of agency-regulated institutions, Farm Credit System institutions, and certain of their subsidiaries. These mortgage loan originators must be registered with the Nationwide Mortgage Licensing System and Registry (Registry), a database established by the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators to support the licensing of mortgage loan originators by the states. The comment period ended on July 9, 2009. The joint press release and *Federal Register* notice can be found at <http://www.federalreserve.gov/newsevents/press/bcreg/20090601a.htm>.

New Truth in Lending Act disclosure requirements on buyers and assignees of home loans under the Helping Families Save Their Homes Act of 2009.

On May 20, 2009, President Obama signed into law the Helping Families Save Their Homes Act of 2009. The law strengthens the Federal Housing Administration's Hope for Homeowners program by providing a safe harbor for servicers who modify home loans and also to give the Federal Deposit Insurance Corporation and the National Credit Union Administration an expanded credit line with the U.S. Treasury. The new law also requires a creditor that purchases or is assigned a mortgage loan secured by the consumer's principal dwelling to provide a written disclosure to the consumer 30 days after the sale or assignment notifying the consumer of relevant information regarding the new creditor. This provision is effective immediately and does not require an implementing regulation. The White House press release can be found at http://www.whitehouse.gov/the_press_office/reforms-for-american-homeowners-and-consumers-president-obama-signs-the-helping-families-save-their-homes-act-and-the-fraud-enforcement-and-recovery-act/.

THE BANK DIRECTOR'S ROLE IN ESTABLISHING A "CULTURE OF COMPLIANCE"

the Board of Governors of the Federal Reserve System wrote that successful compliance risk management starts at the "top of the house."² The board of directors sets the tone of compliance for an institution, not only in words but in actions. An environment should exist where senior management and the organization's staff are not merely comfortable but obliged to communicate compliance risks as issues are identified and help to establish controls. It is the board that must establish this culture of compliance.

HOW MUCH IS ENOUGH?

Before directors can establish a positive culture to effectively oversee consumer compliance risks, they must first identify and clearly understand those risks. Examiners consider this process when they evaluate an organization's board of directors.³ The current volatile environment, from both a regulatory and an economic perspective, makes it challenging for directors to accomplish this mission. The regulatory environment is experiencing an unprecedented period of change, while the current economic climate is also pressuring banks to become more creative in product offerings as a means to generate additional earnings. Adopting and offering more complex products and services, of course, increases the organization's compliance risk. Additionally, the supervisory or audit process may uncover areas of potential weakness within functions that were believed sound from a compliance standpoint.

The good news is that the board of directors is not alone as part of the compliance management program. Directors can, and should, turn to the organization's compliance officer or compliance function to as-

sist in identifying such risks. Armed with appropriate information, the board can then set the risk appetite for the organization as well as the tone of its compliance management program.

Regulators are often asked how directors should approach overseeing consumer compliance in their organization. There is clearly no single correct answer to this question. However, when faced with a new regulatory concern, directors should work with their

AN ENVIRONMENT SHOULD EXIST WHERE SENIOR MANAGEMENT AND THE ORGANIZATION'S STAFF ARE NOT MERELY COMFORTABLE BUT OBLIGED TO COMMUNICATE COMPLIANCE RISKS AS ISSUES ARE IDENTIFIED AND HELP TO ESTABLISH CONTROLS.

compliance management and consider asking the following questions:

- **What?** – What is this regulation/guidance? What is the change? Why was it adopted?
- **Impact?** – What is the impact for our institution? What products does it affect? Do we require system upgrades? What is the difficulty of this new/changed regulation? What is the risk of noncompliance?
- **Cost?** – What is the estimated cost of compliance?

² "A successful compliance risk management program starts at the 'top of the house.' The board and senior management set the tone of compliance for the organization. They must convey a culture of compliance not only in words but also in actions. Culture is also evidenced by the organization's risk appetite, the stature of corporate compliance, the emphasis on full compliance, the compensation of compliance staff, and the penalties for noncompliance, to name a few." Phyllis Harwell, "Managing Consumer Compliance Risks in Today's Economic Environment," *Consumer Compliance Outlook* (First Quarter 2009). Available at: http://www.philadelphiafed.org/bank-resources/publications/consumer-compliance-outlook/2009/first-quarter/q1_02.cfm

³ "In order for the board and senior management to carry out their responsibilities, they need to understand the organization's current compliance risks." Governor Mark W. Olson, "What Are Examiners Looking for When They Examine Banks for Compliance?," speech at the American Bankers Association's Regulatory Compliance Conference, Orlando, Florida, June 12, 2006.

Training? Systems? Forms?

- **Plan?** - What is management's plan for implementing and monitoring compliance?

These suggested questions are only a starting point and do not guarantee insulation from adverse examination findings. They can, however, provide the foundation for the types of discussion that addresses the root of various compliance risks and stimulate the type of interaction seen in an engaged "top down" compliance management program.

APPLYING THE MODEL

Perhaps the most effective way to demonstrate this approach is to apply these suggested discussion topics to an actual regulatory change. On July 14, 2008, the Board of Governors approved final rules amending Regulation Z (Truth in Lending) adopted under the Home Ownership and Equity Protection Act (HOEPA).⁴ These new rules, most of which become effective October 1, 2009, require significant changes that affect residential lending disclosures and mortgage advertising. The following points provide an example of the type of information a board may want to obtain from a compliance function presentation on the HOEPA final rules.

What?

- These amendments to the regulation create a new "higher-priced mortgage" (HPM) category with new accompanying protections. They also add new protections to all closed-end loans secured by a consumer's principal dwelling. Finally, they create additional advertising restrictions on residential lending.
- The goal of the amendments is to protect consumers from abusive, unfair, or deceptive acts or practices in lending, servicing, or advertising. The changes are designed to preserve responsible lending and sustainable homeownership.

Impact?

- This is not just a subprime regulation. The HPM threshold trigger of 1.5 percent over average prime mortgage offer rates for first liens is low enough to affect some conforming loans.
- The HPM rules apply to first- and second-lien home purchase, refinance, and home equity loans

secured by the consumer's principal dwelling. It does not apply to home equity lines, construction loans, or reverse mortgages.

- The HPM protections include underwriting requirements, restrictions on prepayment penalties, and requirements for escrow accounts on first-lien loans.
- The final rules also impose certain restrictions on all credit secured by a consumer's principal dwelling and requires earlier disclosures on all closed-end mortgages.
- The amendments create several new advertising standards, including additional information about rates, monthly payments, and other loan features. The final rule also bans seven deceptive or misleading advertising practices.
- These are fairly comprehensive rules requiring changes in existing procedures, additional reporting requirements with regard to the Home Mortgage Disclosure Act (HMDA), possible system modifications, and training across several business lines.
- Truth in Lending provisions are strongly enforced by regulators.

Cost?

- Training will be required across several business lines. Underwriters will need to be instructed on the new restrictions. HMDA reporting will need to capture the new HPMs. Marketing will need to be aware of the new requirements.
- System vendors will need to be contacted to determine what aspects can/should be automated.
- New internal worksheets and checklists may need to be created.

Plan?

- The compliance function will continue to become familiar with the new rules.
- A roll-out plan for full compliance will be developed with time frames in accordance with the mandatory compliance date.
- Senior management will be provided with a high-level summary of the changes.
- A survey of affected business lines and processes will be conducted.
- Affected staff will receive training on the final rules.

⁴ The announcement and final rulemaking are available on the Board's website at <http://www.federalreserve.gov/newsevents/press/bcreg/20080714a.htm>.

- The compliance function will work in conjunction with business line management to assist in the modification of procedures, checklists, and systems.
- A system vendor will be contacted to ensure that proper modifications are in place.
- A regulator will be contacted for consultation/questions.
- A final survey of the roll-out plan will be conducted prior to the mandatory effective date.

SUMMARY

This example is more of an outline, but it helps to demonstrate an important point: The most effective

compliance risk management programs are proactive and driven by the board of directors. By engaging the compliance function, the board accomplishes two important tasks: 1) directors receive the information they need to be better informed on compliance issues and better equipped to set the organization's risk appetite; and 2) the board establishes the expectation that compliance is a priority, thereby establishing a "culture of compliance." Specific issues and questions should be raised with the consumer compliance contact at your Reserve Bank or with your primary regulator. ©

CONSUMER COMPLIANCE RESOURCES

Listed below are important compliance resources for financial institutions. A more comprehensive list of resources and the corresponding links are available on *Consumer Compliance Outlook's* web page at: www.consumercomplianceoutlook.org.

RESOURCE	DESCRIPTION
Overall Consumer Compliance	
Federal Reserve's Consumer Compliance Handbook	Manual used to conduct compliance examinations of state member banks
Federal Reserve Board's Regulations	The Board's regulations, including recent amendments
Fair Lending and Equal Credit Opportunity Act (ECOA) — Regulation B	
Justice Department's Fair Lending and Fair Housing Site	Collection of fair housing and fair lending resources from the Justice Department
Banker's Guide to Risk-Based Fair Lending Examinations	Overview of the interagency fair lending examination procedures from the Federal Reserve Bank of Chicago
Home Mortgage Disclosure Act (HMDA) — Regulation C	
HMDA Getting It Right	Guide to recording and reporting HMDA data
FFIEC Rate Spread Calculator	Online calculator to determine if a loan must be reported as a rate-spread loan
Flood Insurance — Regulation H	
FEMA's Flood Insurance Purchase Guidelines (Sept. 2007)	FEMA requirements when purchasing flood insurance
FEMA's Flood Regulation	FEMA's regulation about flood insurance coverage and rates
FEMA's Flood Insurance Purchase Page	Information about FEMA's flood insurance program
FEMA Map Service Center	Resource for FEMA flood maps
Real Estate Settlement Procedures Act (RESPA) — Regulation X	
HUD's RESPA Page	Collection of RESPA resources
Truth in Lending Act (TILA) — Regulation Z	
OCC APR Calculator	Software to verify annual percentage rates
Community Reinvestment Act (CRA) — Regulation BB	
FFIEC CRA Resource Page	Collection of CRA resources
CRA Interagency Questions & Answers	Frequently asked questions about the Community Reinvestment Act
Banker's Quick Reference Guide to CRA	A guide to CRA regulation and examination procedures from the Federal Reserve Bank of Dallas
Truth in Savings Act (TISA) — Regulation DD	
OCC APY Calculator	Software to verify annual percentage yields
Fair Credit Reporting Act (FCRA)	
FTC Fair Credit Reporting Act Page	Collection of FCRA resources

AN OVERVIEW OF THE HOME AFFORDABLE MODIFICATION PROGRAM

is, the loan balance exceeds the current value of the home. When re-default is likely, the rational choice for a servicer is to initiate foreclosure proceedings when the homeowner becomes delinquent and sell the home at a sheriff's sale.

Hope for Homeowners

To address the shortcomings of previous programs, including the problem of declining house values, the Bush administration announced the creation of the Hope for Homeowners Program (H4H) on October 1, 2008, which allows homeowners to refinance their mortgages with a mortgage insured by the Federal Housing Administration (FHA). To be eligible for the program, the borrower must be seeking to refinance a mortgage on his primary residence and cannot have an interest in any other residential property. Also, the homeowner must have a front-end DTI ratio that exceeds a threshold ratio of 31 percent.

For lenders, H4H currently requires that first-lien holders accept 96.5 percent of the appraised value of the home as payment for all outstanding claims.⁶ If the first-lien holder accepts this lower principal amount, the mortgage is refinanced into an FHA-insured loan. The homeowner must pay an upfront mortgage insurance premium of up to 3 percent and an annual premium of up to 1.5 percent.⁷

Streamlined Modification Program

Similar to the "Mod in a Box" program, the Streamlined Modification Program uses an affordability measure to modify mortgages held by government-sponsored enterprises (GSEs). To quickly modify mort-

gages at risk of default, the program modifies first liens to reduce the homeowner's front-end DTI ratio to 38 percent. Under the program, servicers can take the following actions, in the listed order, when modifying a mortgage:

1. To reduce the homeowner's front-end DTI ratio to 38 percent, the servicer can extend the term of the mortgage.
2. If the homeowner's front-end DTI ratio still exceeds 38 percent after the term of the mortgage has been extended, the servicer can reduce the interest rate on the mortgage in increments of 0.125 percent. However, the interest rate on the mortgage cannot fall below a floor of 3 percent.⁸
3. If the homeowner's front-end DTI ratio still exceeds 38 percent, the last option available to servicers is to delay repayment on a portion of the principal. The deferred principal will be paid as an additional balloon payment due upon sale, payoff, or maturity.

The eligibility requirements for the Streamlined Modification Program include that the house securing the mortgage must be the homeowner's primary residence and that a GSE must own or must have securitized the loan. In addition, only homeowners who are at least 90 days past due on their mortgage, have documentation that they encountered some financial hardship, and have a CLTV on their home that is greater than 90 percent are eligible for the program. One important innovation of the Streamlined Modification Program is that it provides an \$800 incentive payment from the GSEs to the servicers for each mortgage that is modified.

⁶ In November 2008, the Department of Housing and Urban Development made changes to the program because few lenders were participating under the program's original terms. <http://www.hud.gov/news/release.cfm?content=pr08-178.cfm> In addition, Congress enacted the Helping Families Save Their Homes Act of 2009 in May 2009. http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_public_laws&docid=f:publ022.111.pdf Section 202 of this law also made changes to H4H to encourage more lenders and borrowers to participate.

⁷ The H4H program also requires subordinate mortgage lenders to release their outstanding claims against the homeowner. Homeowners are restricted from taking on a second mortgage for up to five years and must share future price appreciation of the home if the home is sold.

⁸ If the modified interest rate is set below the prevailing market interest rate for mortgages of similar term, the modified interest rate will gradually increase after five years to either the original interest rate or the market interest rate at the time of the modification.

HAMP

These previous government mortgage modification programs have had mixed results in reducing foreclosures and avoiding re-default, depending on the type of mortgage (prime, subprime, etc.), the type of modification (e.g., reducing the loan payment), and whether the servicer performing the modification is servicing the loan for a third party or in its own portfolio. For example, the Fitch ratings service released a report earlier this year showing the re-default rate for modified subprime, securitized loans was between 65 percent and 75 percent.⁹ But a recent Mortgage Metrics Report from the Office of the Comptroller of the Currency and the Office of Thrift Supervision, which analyzed the loan performance at nine national banks and four thrifts with the largest mortgage portfolios, found that “modifications that decreased monthly payments had consistently lower re-default rates, with greater percentage decreases [in monthly payments] resulting in lower subsequent re-default rates.”¹⁰ The report also found the re-default rate for modified mortgages was generally lower if the borrower’s payment was reduced by more than 10 percent.¹¹

Another issue with the previous programs is that they were voluntary. HAMP requires that all banks and lending institutions accepting funding from the Troubled Asset Relief Program (TARP), after the announcement of HAMP in March 2009, must implement loan modifications for eligible loans under HAMP’s guidelines. For non-TARP banks, participation is voluntary. Institutions participating are required to sign a con-

tract with the Treasury agreeing to review all loans for potentially eligible borrowers who call or write asking to be considered for the program. It is important to note that participating servicers are still bound by the pooling and servicing agreements when modifying loans. However, HAMP still requires institutions to make every effort to help facilitate loan modifications within the constraints of their pooling and servicing agreements.

Under HAMP, all first-lien loans are eligible for modification as long as they do not exceed GSE conforming loan limits of \$729,750 for a single-unit property. Other requirements are that the property must be a primary residence and cannot be vacant or condemned. It is also necessary that borrowers experience a finan-

HAMP REQUIRES THAT ALL BANKS AND LENDING INSTITUTIONS ACCEPTING FUNDING FROM THE TROUBLED ASSET RELIEF PROGRAM (TARP), AFTER THE ANNOUNCEMENT OF HAMP IN MARCH 2009, MUST IMPLEMENT LOAN MODIFICATIONS FOR ELIGIBLE LOANS UNDER HAMP’S GUIDELINES.

cial hardship that hampers their ability to pay their mortgage, leading to delinquency or the risk of “imminent default.”¹²

Similar to the Streamlined Modification Program and “Mod in a Box,” HAMP allows servicers and lenders to use a standard process to modify eligible mortgages. Loans are modified to increase their affordability and

⁹ Carrick Mollenkamp, “Mortgage Modifying Fails to Halt Defaults,” *Wall St. Journal*, May 26, 2009, p.C3. <http://online.wsj.com/article/SB124330158365953109.html> (subscription required). This statistic was based on a re-default definition of 60 days or more delinquent within 12 months of the loan change.

¹⁰ OCC and OTS Mortgage Metrics Report, First Quarter 2009, p. 32, available at <http://occ.gov/ftp/release/2009-77a.pdf>. The OCC and OTS release updated versions of this report each quarter. The first report was issued in June 2008. <http://www.occ.treas.gov/ftp/release/2008-65.htm>

¹¹ Ruth Simon, “Study Buys Mortgage Modification,” *Wall St. Journal*, April 4, 2009, p. B2, available at <http://online.wsj.com/article/SB123875775797386333.html> (subscription required).

¹² HAMP guidelines (March 4, 2009) define “imminent default” as the inability to stay current as a result of a change in circumstances caused by financial hardship or as a result of a recent increase in the mortgage payment that is likely to cause financial hardship. http://www.ustreas.gov/press/releases/reports/modification_program_guidelines.pdf

reduce foreclosures. To accomplish this, servicers are required to determine the monthly mortgage payment a borrower can afford¹³ and sustain long term and then modify the existing mortgage until the front-end DTI ratio equals 31 percent.¹⁴ Fifty percent of the costs incurred to reduce a borrower's front-end DTI ratio from 38 percent to 31 percent are incurred by the U.S. Treasury. Further front-end DTI reductions below 31 percent are allowed but are not subsidized by the Treasury.

To encourage servicers to modify mortgages, HAMP provides servicers with a one-time up-front payment of \$1,000 for each delinquent mortgage they modify.¹⁵ If the mortgage holder's loan remains current after the mortgage has been modified, the servicer can earn an additional \$1,000 per year over a five-year period.¹⁶

One concern expressed by the mortgage industry about modifications was that in an environment in which real estate prices are declining, it often makes more sense for lenders to foreclose than to modify a mortgage. If a defaulted loan is modified and the borrower re-defaults, and the property is worth less at re-default, the lender likely would have been better off foreclosing when the original default occurred and the property was more valuable. To address this concern, HAMP provides some protection against falling house values associated with default following modification under the Home Price Decline Protection (HPDP) initiative. Specifically, this initiative provides owners and servicers with cash compensation for making loan modifications on properties located in areas with declining home prices.¹⁷

Another important feature of HAMP is that the Treasury requires lenders and servicers to apply a consistent process in calculating an affordable loan modification. In fact, the HAMP approach is similar to the process used in "Mod in a Box": A loan can be modified only if it yields a positive NPV using a "waterfall" procedure. The "waterfall" means that lenders and servicers must follow an established sequential process when applying the NPV test to determine which loan modification to use to achieve a targeted front-end DTI ratio of 31 percent.

The steps of the "waterfall" are as follows:

Step 1: **Capitalization.** Capitalize arrearages, such as accrued interest and past due real estate taxes and insurance payments.

Step 2: **Reduced Interest Rate.** The servicer must reduce the interest rate by increments of 0.125 with a floor of 2 percent, in order to reach the targeted front-end DTI ratio of 31 percent. If the modified interest rate is lower than the Freddie Mac Primary Mortgage Survey Rate for 30-year fixed-rate conforming mortgage loans, the modified interest rate will be in effect for the first five years of the modification.¹⁸

Step 3: **Extended Term.** If the targeted front-end DTI ratio cannot be reached by reducing the interest rate, the servicer can extend the term of the loan and amortize the mortgage by up to 40 years from the date of origination.

Step 4: **Principal Forbearance.** If the front-end DTI ratio has not reached 31 percent after reducing the interest rate and extending the term of the mortgage, the servicer can engage in

¹³ To verify income, the borrower must provide the two most recent paystubs and a signed copy of his most recently filed federal income tax return, while the servicer must confirm that the property subject to the mortgage is the borrower's primary residence.

¹⁴ The calculation of this ratio is similar to that used by the "Mod in a Box" program. The debt portion of the ratio includes housing-related debt only and does not incorporate other debt incurred by the borrower.

¹⁵ To ensure that loans are modified in a responsible manner, HAMP requires that all modified loans under the program be required to pass a 90-day "trial period" before financial incentives are distributed to owners/servicers. The "trial period" is similar to the process used in the Streamlined Modification Program and the "Mod in a Box" program.

¹⁶ Unlike earlier loan modification programs, HAMP allows servicers to earn an additional \$500 payment if the mortgage holder is not delinquent, but default is imminent.

¹⁷ Payments for declines in house prices are not tied to the actual value of the homes with the modified mortgage but to a decline in a general housing index. The details about the HPDP initiative are provided in the Treasury Department's supplemental directive 09-04, which is available at: <http://www.financialstability.gov/docs/press/SupplementalDirective7-31-09.pdf>. Exhibit C to the supplemental directive provides an example of an HPDP calculation.

¹⁸ After the first five years, the annual interest rate increases by 1 percent a year until the interest rate reaches the lesser of the Freddie Mac Primary Mortgage Market Survey Rate or the originally contracted interest rate.

principal forbearance, where no interest may accrue on the forbearance amount. Principal forgiveness can be used at any stage of the “waterfall” but is not permitted on GSE loans. In addition, the U.S. Treasury does not bear modification costs if a mortgage is modified using principal forgiveness.

Revisions to HAMP. On April 28, 2009, the U.S. Treasury announced two enhancements to HAMP. The first clarifies and emphasizes that H4H is the preferred form of loan assistance to the borrower before seeking assistance under HAMP. Servicers are required to evaluate and offer all eligible homeowners the option of having their loan refinanced using the guidelines established under H4H. As an additional incentive to offer H4H to homeowners, servicers will receive a \$2,500 up-front payment for every refinancing using H4H, which is higher than the \$1,000 up-front payment servicers receive when modifying loans using the “waterfall” approach.¹⁹

The second enhancement discusses how second-lien holders are addressed under HAMP. The original announcement was short on details, but on August 13, 2009, the Treasury Department published supplemental directive 09-05 for the Making Home Affordable Program, which discusses in detail the procedure for modifying second-lien mortgages, known as the Second Lien Modification Program (2MP).²⁰ Under this program, “when a borrower’s first lien is modified under HAMP and the servicer of the second lien is a 2MP participant, that servicer must offer either to modify the borrower’s second lien according to a defined protocol or to accept a lump sum payment from Treasury in exchange for full extinguishment of the second lien. The 2MP offer will be made in reliance on the financial information provided by the borrower in conjunction with the HAMP modification and without additional evaluation by the second lien servicer.”

The directive identifies the eligibility requirement for second-lien loan modifications and extinguishment:

- Only second liens with corresponding first liens that have been modified under HAMP are eligible for a modification or extinguishment under 2MP.
- Second liens originated on or before January 1, 2009 are eligible for a modification or extinguishment under 2MP.
- Only second liens with an unpaid principal balance (at initial consideration for the second-lien modification) equal to or greater than \$5,000 are eligible for modification incentive or cost share payments under 2MP. There are no unpaid principal balance limitations for investor incentive payments in conjunction with extinguishment of second liens under 2MP.
- A second lien may be modified only once under 2MP.
- A mortgage loan that is subordinate to a second lien is ineligible under 2MP. Modification or extinguishment of such a subordinate mortgage loan in place of the second lien will not satisfy the servicer’s obligation under 2MP to modify or extinguish the second lien.
- If a second lien is modified under 2MP, it is not eligible for payment of extinguishment incentives under 2MP.
- A home equity loan that is in first-lien position is not eligible under 2MP and should be evaluated for modification under HAMP.
- A mortgage lien that would be in second-lien position but for a tax lien, a mechanic’s lien, or other non-mortgage-related lien that has priority is eligible under 2MP.
- A second lien on which no interest is charged and no payments are due until the first lien is paid in full (e.g., FHA partial claim liens and/or equity appreciation loans) is not eligible under 2MP.
- Borrowers may be accepted into the program if a fully executed 2MP modification agreement or trial period plan is in the servicer’s possession on December 31, 2012.²¹

Compensation for second-lien modification is provided by the Treasury Department. To modify or extin-

¹⁹ The preferential status of H4H in HAMP may help invigorate H4H as a viable loan modification program. One benefit that H4H has over the other loan modification techniques within the HAMP “waterfall” is that a loan modified under H4H is permanently removed from the investor’s/lender’s portfolio and becomes a future liability of the U.S. government.

²⁰ The second lien program directive is available at https://www.hmpadmin.com/portal/docs/second_lien/sd0905.pdf.

²¹ Supplemental Directive 09-05, p. 2.

guish second liens, investors, lenders, and mortgage servicers must be active participants in the program. If an interest rate reduction is used to modify the second lien, investors and lenders are paid 50 percent of the difference between the new modified interest rate of 1 percent for a fully amortized mortgage and the original interest rate on the loan. If the investor or lender agrees to extinguish his lien, a payment of 3 percent of the unpaid balance of the loan is distributed if the claim is more than 180 days delinquent. A higher payment is allocated ranging from 4 percent to 12 percent of the unpaid balance of the loan if the claim is less than 180 days delinquent.

Servicers are compensated to modify second liens but receive less compensation for second-lien modifica-

BECAUSE HAMP INCORPORATES THE LESSONS LEARNED FROM PREVIOUS PROGRAMS, THERE IS AN EXPECTATION THAT IT WILL BE MORE SUCCESSFUL.

tions than for first-lien modifications. For example, mortgage servicers receive a \$500 up-front fee to modify second liens. In addition, servicers can receive a payment of \$250 per year for up to three years if the second lien remains current. It is also important to note that borrowers can also earn a \$250 payment per year for a five-year period if they remain current on their mortgage.²²

What Makes HAMP Different? HAMP attempts to address the factors contributing to foreclosure and re-default that were not effectively addressed in the previous government-sponsored loan modification pro-

grams. As discussed earlier, the primary factors contributing to foreclosure and re-default are mortgage affordability and home price depreciation. HAMP is expected to be more successful by providing a comprehensive way to affect these factors and by creating new processes to tackle issues. The main changes from prior programs are that HAMP:

1. Addresses the issue of who bears the cost by allowing the U.S. Treasury to share 50 percent of the cost to reduce a borrower's front-end DTI ratio from 38 percent to 31 percent.
2. Creates an incentive for mortgage servicers to participate in the program by paying servicers a fee to modify mortgages. Servicers can receive additional compensation if the mortgages they modify remain current.
3. Compensates investors and lenders as house prices decline on mortgages that are modified to reduce the cost associated with re-default and to encourage participation.
4. Modifies mortgages that are current but are at "imminent risk of default."
5. Provides a platform that allows lenders and servicers to consistently and uniformly modify mortgages at risk of default. A uniform standard should reduce the cost to servicers and the variation in outcomes, leading to a reduction in foreclosures.

CONCLUSION

It will take some time before the Treasury Department can evaluate whether HAMP has been successful in meeting its objectives of reducing the number of foreclosures through mortgage modifications. Because HAMP incorporates the lessons learned from previous programs, there is an expectation that it will be more successful. Specific issues and questions should be raised with the consumer compliance contact at your Reserve Bank or with your primary regulator. ©

²² Servicers and investors/lenders can be compensated for extinguishing second liens without modifying the first lien. However, for a loan to be modified under H4H, the second lien must be extinguished.

COMPLIANCE ALERT: REGULATION Z INTERIM FINAL RULE IN EFFECT

On July 15, 2009, the Board announced an interim final rule for Regulation Z to implement sections 101(a) and 106(b) of the Credit Card Accountability Responsibility and Disclosure Act of 2009 (CARD Act), which became effective on August 20, 2009, as follows:

- Creditors must provide written notice to consumers 45 days before increasing an annual percentage rate on a credit card account or making a “significant change” to the terms of a credit card account. The interim final rule defines “significant change” to include changes in annual percentage rates, fees for issuance or availability, fixed finance charges, transaction charges, grace periods, balance computation methods, cash advance fees, late fees, over-the-limit fees, balance transfer fees, return payment fees, and required insurance, debt cancellation, or debt suspension coverage.
- Creditors must inform consumers in the same notice of their right to cancel the credit card account before the increase or change goes into effect. If the consumer closes the account, creditors are generally prohibited from applying the increase or change to the account. The rule also addresses permissible repayment terms for the account balance if the consumer rejects the creditors’ changes and closes the account. Additionally, there are prohibitions for imposing penalties or fees as a result of the consumer’s rejection of the changes and closure of the account.

- Creditors generally must mail or deliver periodic statements for open-end credit accounts at least 21 days before payment is due and adopt reasonable procedures to accomplish this. The rule also generally prohibits a creditor from treating a payment as late or imposing additional finance charges unless the creditor mailed or delivered the periodic statement at least 21 days before the payment due date. **While most of the provisions of the CARD Act apply only to credit cards, the periodic statement rule in section 106(b) applies to all open-end credit accounts, including home equity lines of credit.**

Comments on the interim final rule were due by September 21, 2009. The other provisions of the CARD Act are being implemented in two phases and become effective on either February 22, 2010 or August 22, 2010. The Board will publish amendments to Regulation Z to implement these provisions in the future. The Board’s announcement and the interim final rule are available at <http://www.federalreserve.gov/newsevents/press/bcreg/20090715a.htm>.

CONTINUED FROM PAGE 5...

MORTGAGE DISCLOSURE IMPROVEMENT ACT OF 2008 - AMENDMENTS TO REGULATION Z

disclosures three business days after they are deposited with a courier or sent by e-mail.

4. **If we have evidence of actual receipt (by e-mail, courier, or other method), can we start the three-business-day waiting period sooner?**

Yes. If a creditor delivers disclosures via one of these, or other, methods, the creditor may rely on evidence of actual receipt to determine when

the three-business-day waiting period begins. Because the Board did not specify standards for acceptable evidence, it is up to the institution to document receipt.

5. **Does the E-Sign Act apply when delivering the early and corrected TILA disclosures electronically?**

Yes.

6. Are corrected disclosures required when the APR is overstated on the early disclosures? What if this overstatement is the result of fees being waived at or near consummation?

The rule specifies that if the APR is inaccurate as determined under §226.22(a), a corrected disclosure is required and the three-business-day waiting period prior to consummation would apply. Sections 226.22(a)(2) and (a)(3) state that APRs are considered accurate if they are not more than one-eighth (for regular transactions) or one-quarter (for irregular transactions) of 1 percent, respectively, above or below the actual APR, as determined in accordance with §226.22(a)(1). Thus, some overstated APRs may require corrected disclosures just as understated APRs do.

of them? Do these disclosures need to be in separate envelopes, or can they be included in the same envelope?

Yes, multiple borrowers entitled to disclosures must each receive their own copy of the disclosure. Regulation Z does not specify how many envelopes must be used.

8. When is an application considered to be received by the creditor?

Section 226.19(a)(1)(i) states that a creditor shall deliver or place in the mail good-faith estimates of the disclosures required by §226.18 not later than three business days after the creditor receives the consumer's written application. This timing requirement runs from the time the creditor receives the application. If the application comes to the creditor from an "intermediary agent or broker," the timing runs from when the creditor received the application, not when the agent or broker received it from the consumer (see comment 19(b)-3 for guidance in determining whether the transaction involves "an intermediary agent or broker"). Comment 19(a)(1)(i)-3 of the OSC states that creditors may rely on RESPA and Regulation X (including any interpretations issued by the Department of Housing and Urban Development) in deciding whether a written application has been received. Regulation X defines "application" in §3500.2(b).


MULTIPLE BORROWERS ENTITLED TO DISCLOSURES MUST EACH RECEIVE THEIR OWN COPY OF THE DISCLOSURE.

However, paragraphs (a)(4) and (a)(5) contain additional tolerances for APR accuracy on mortgage loans. Specifically, for a mortgage loan, the disclosed APR is considered accurate under §226.22(a)(4) if the rate is overstated but results from the disclosed finance charge which is also overstated. Further, under §226.22(a)(5), a disclosed APR that is closer to the actual APR than the APR that would be considered accurate under §226.22(a)(4) is also considered accurate. Creditors should closely examine these two paragraphs when determining whether an APR that is overstated is inaccurate and thus requires corrected disclosures and a three-business-day waiting period.

Note that §226.17(f) may also require a corrected disclosure (but no three-business-day waiting period) before consummation. This requirement is triggered if any aspect of the earlier disclosure, as opposed to only the APR, has become inaccurate.

7. If there are multiple borrowers entitled to disclosures living at the same address, do we need to mail separate disclosures to each

CONCLUSION

The provisions implementing the MDIA discussed in this article are in §226.19 of Regulation Z. The *Federal Register* notice is available at: <http://edocket.access.gpo.gov/2009/pdf/E9-11567.pdf>. Implementing these new rules has proven a significant undertaking for many institutions, with many more changes to mortgage lending rules becoming effective in the next few months. Lenders should continue to monitor and update their systems and other control processes to ensure compliance with these rules. Specific questions should be raised with the consumer compliance contact at your Reserve Bank or with your primary regulator. 

CALENDAR OF EVENTS

October 2-8 National Compliance School
American Bankers Association
Emory Conference Center Hotel, Atlanta, GA

October 4-10 Compliance Institute
Independent Community Bankers of America
Embassy Suites, Kansas City, MO

October 18-20 Fair Lending Conference
Consumer Bankers Association
Omni Shoreham, Washington, D.C.

November 6 Fifth Annual Community Bankers Symposium
Federal Reserve Bank of Chicago
230 South LaSalle Street, Chicago, IL