



The Oak Tree Advantage

► REFINING LENDING PRACTICES

Genelle Rich, President



As we all know, there are great lending opportunities for credit unions, though managing loan processes in 2010 got more difficult. Areas of change that have had a significant bearing on the credit union industry in 2010 and affect how credit unions will plan for the future include the current credit environment and the ever-changing regulatory landscape. No question the last two years have been difficult and we have all become more involved with regulatory concerns that force continual refinement of lending practices.

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In interactions with our current clients, we have noticed that directors and senior executives are creating decision-making frameworks that more clearly articulate lending expectations throughout their organizations. In addition, credit policies are being readdressed to ensure appropriate risk tolerances are set and expectations are firmly established relating to current lending practices in their institutions. With all this change, what is next?

In 2011, we will see more of the same, but perhaps less of it. Upcoming regulatory issues to be addressed include:

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| 12/31/2010: Reg. P (GLBA) | Elimination of safe harbor for sample clauses in privacy rules |
| 1/1/2011: Reg. V (FACTA) | Risk-based pricing notices |
| 1/1/2011: Reg. Z (TILA) | Final rule for disclosures under Helping Families Save Their Homes Act |

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▶ OPEN-END AND CLOSED-END LENDING ERUPTS IN CHANGES

Michael A. Kus

The open-end lending landscape has changed. After years of lying dormant, with only an occasional rumble, Regulation Z began to show signs of an impending eruption when the Federal Reserve Board announced in 2005 that it was undertaking a comprehensive review of its primary consumer lending regulation. The Board made it known that it would reevaluate its disclosure requirements and would also conduct extensive consumer testing in an effort to ensure that consumers were given clear and concise information when seeking credit. When a series of Proposed Rules were issued beginning in 2007, the scale of the potential eruption became clear: there would be a significantly different regulatory landscape once the Final Rules were released.

The revised and enhanced Regulation Z requirements for open-end credit disclosures were finalized in January, 2009, slated to be effective July 1, 2010. The timing of these comprehensive changes was unfortunate: the financial crisis that would come to be known as the Great Recession had already become apparent by the second half of 2008. Spurred into action, Congress addressed a wide array of financial issues and passed a series of laws, including amendments to the Truth In Lending Act. One of these new laws was the Credit Card Act (May 2009), which required the Board to issue a series of changes to the Regulation Z open-end credit regulations throughout 2009 and early 2010. Because the new law required changes to portions of the regulation already covered by the January 2009 Final Rule, the January 2009 Final Rule was withdrawn and replaced with a new Final Rule issued in February 2010. This fragmented shake-up of the open-end credit rules meant that an orderly transition for lenders was no longer possible.

One of the details of the January 2009 Final Rule that was obscured by all of these cataclysmic changes was the Board's clarification of the definition of Open-End Credit found in the Official Staff Commentary to Regulation Z. A seemingly minor change, the revision to the Commentary focused on the actions a creditor could take with respect to a request for a credit advance under an open-end credit plan. Essentially, the Board said that only a certain level of verification was permitted when evaluating a request for credit under an open-end plan. It identified "underwriting" as an event that would cause a credit advance to be considered closed-end credit instead of an open-end credit advance.

The amendment to the Commentary for the definition of Open-End Credit (§ 226.2(a)(20)) specifies that advances made under such a plan may be subject only to periodic or routine verification of the consumer's credit standing, which may include verification of the value of any collateral offered. The "underwriting" of

an advance (that is, a more stringent analysis of the consumer's circumstances) with a subsequent determination to either extend credit or decline the request causes such an advance to no longer meet the definition of open-end credit. The Supplementary Information published with the January 29, 2009 Final Rule (74 FR 5260) stated, in pertinent part:

...The changes to comment 2(a)(20)-5 are adopted as proposed.... Under revised comment 2(a)(20)-5, verification of a consumer's creditworthiness consistent with the statute continues to be permitted in connection with an open-end plan; however, underwriting of specific advances is not permitted for an open-end plan. The Board believes that underwriting of individual advances exceeds the scope of the verification contemplated by the statute and is inconsistent with the definition of open-end credit. The Board believes that the rule does not undermine safe and sound lending practices, but simply clarifies that certain types of advances for which underwriting is done must be treated as closed-end credit with closed-end disclosures provided to the consumer.

The long-standing practice of making an automobile or RV loan by advancing funds and establishing an amortized repayment term under the auspices of a consumer's open-end credit agreement no longer satisfies the definition of open-end credit if the credit union underwrites that request.

The February 22, 2010 Final Rule reaffirms the Board's long-standing position that there are only two types of consumer credit – open-end credit and closed-end credit (which is any type of credit that does not meet the definition of open-end credit). With respect to requests for credit that are underwritten by a lender, the Final Rule makes it clear that the Board's position is that closed-end credit disclosures are required because such transactions are closed-end credit.

This distinction has a direct bearing on the multi-featured open-end lending plans that have been offered by credit unions for many years. The long-standing practice of making an automobile or RV loan by advancing funds and establishing an amortized repayment term under the auspices of a consumer's open-end credit agreement no longer satisfies the definition of open-end credit if the credit union underwrites that request. Significantly, this means that if a credit advance request will require underwriting in order to properly assess the risk involved and to determine whether credit should or should not be extended, then the transaction should be handled as a closed-end transaction (complete with closed-end disclosures). By the same token, if the credit union is willing to assume the risks associated with merely verifying the consumer's credit standing and, when appropriate, establishing the value of any collateral as specified in the Commentary, then the transaction may be appropriately handled as an advance under an open-end plan.

While the Commentary makes it clear that underwriting a request for credit means that the credit

is closed-end credit, it is important to remember that this distinction extends beyond the initial disclosures furnished to borrowers. Open-end credit is governed by Subpart B of Regulation Z, and is subject to specific subsequent disclosure requirements (§ 226.9), while closed-end credit is governed by Subpart C, and is subject to different subsequent disclosure requirements (§ 226.20). The primary purpose behind the Board's clarification of the definition of Open-end Credit was to make it clear that the long-standing practice of treating "termed advances" (essentially, closed-end transactions) as if they were open-end credit advances is not appropriate. The Board has said that closed-end credit must receive closed-end credit disclosures. Importantly, they have not said that providing closed-end disclosures for certain advances under an open-end credit plan will satisfy the requirements of the regulation; the disclosure requirements for each type of credit are specified in two mutually-exclusive Subparts of Regulation Z, as Congress intended.

As always, the burden of making the judgment call about the nature of a particular credit extension rests squarely on the shoulders of the credit union. Credit unions must be careful to evaluate requests for credit, and then categorize the transaction accordingly. A clear alternative is to offer two separate and distinct product types, one for open-end credit, and another for closed-end credit. Depending on a borrower's needs, they should be directed to the appropriate product. The multi-featured plans that have been a staple of credit union lending for some time, which offer both "revolving" and "termed" advances under an open-end

credit agreement, can no longer rely on underwriting when making a credit decision. Those loans that require underwriting in order to make an informed credit decision should be handled as closed-end credit transactions.

In the ever-changing regulatory landscape of 2010, several features stand out. The Board is moving in the direction of discouraging lenders from offering complex consumer loan products because the Board believes that many consumers do not understand the nature of the credit products they are choosing, to their detriment. This can be seen with the recent changes to the credit card rules, as well as the recently released rules affecting residential mortgage loans, all of which relied heavily on consumer testing of various disclosures. The passage of the Wall Street Reform Act, which creates the Bureau of Consumer Financial Protection, means that there will be a new central authority for consumer lending regulations, including those that govern credit unions. The newly appointed head of that agency has already made it is clear that financial institutions will be closely examined to be sure that they are not "taking advantage" of consumers. Coupled with the added emphasis that the Federal Reserve Board has placed on the distinction between open-end and closed-end credit in the context of multi-featured plans, it is clear that such plans will receive greater scrutiny from regulators.

Credit unions must become familiar with the new paths laid out in the regulatory landscape; some of the old paths no longer exist.



▶ TRUTH-IN-LENDING DISCLOSURE ("TIL") CONTENT CHANGES YET AGAIN

Rod G. Terry, Director Of Product Management

Last year, the Mortgage Disclosure Improvement Act ("Act") amended Regulation Z and required the "TIL" to include a statement informing consumers that they need not complete the transaction because they had received the disclosure. The Act also required creditors to give good faith estimates of mortgage loan costs ("early disclosures") within three business days after receiving a consumer's application for a mortgage transaction subject to the Real Estate Settlement Procedures Act (12 U.S.C. 2601 et seq.) that was secured by the consumer's dwelling, and before any fees are collected from the consumer, other than a reasonable fee for obtaining the consumer's credit history. In addition, the Act required that creditors: (i) wait seven business days after they provide the early disclosures before closing the loan; and (ii) provide new disclosures with a revised annual percentage rate (APR), and wait an additional three business days before closing the loan, if a change occurs that makes the APR in the early disclosures inaccurate beyond a specified tolerance.

On Friday, September 24, 2010 an interim rule was published in the Federal Register that amends Regulation Z such that creditors extending consumer credit secured by real property or a dwelling will be required to disclose certain summary information about interest rates and payment changes, in a tabular format, as well as include a statement that consumers are not guaranteed to be able to refinance their transactions in the future. The interest rate

and payment summary tables replace the payment schedule previously required as part of the TIL for mortgage transactions. Disclosures for closed-end consumer credit not secured by real property or a dwelling will continue to include the current payment schedule. Oak Tree and their counsel have reached out to the Federal Reserve Board and after multiple conversations have determined that each TIL that is furnished must be specific to the particular type of transaction (e.g. fixed-rate fully amortized, fixed-rate balloon payment, variable-rate fully amortized, variable-rate balloon payment, etc.), and that multipurpose TILs that utilize the check-a-box methodology will no longer be permitted. This interim rule is effective October 25, 2010, and compliance is optional until January 30, 2011, at which time its requirements are mandatory for creditors that receive an application for credit on or after that date.

Congress's passage of the Dodd-Frank Wall Street Reform And Consumer Protection Act will likely result in further as yet unknown changes in the TIL's content. For these reasons, the TIL that has been historically integrated into the closing document has outlived its useful life. Therefore, Oak Tree is in the process of modifying the current preliminary TIL into a general-purpose document that will be used initially for redisclosure when applicable, and again at closing as applicable. In addition, the current TIL that resides in the closing document will be removed in its entirety.



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▶ SPANISH LANGUAGE FORMS AVAILABLE THROUGH OAK TREE

Margaret Bennett, Account Executive

Did you know that Oak Tree Business Systems offers Spanish-language documents? Any of your Oak Tree documents can take advantage of Spanish translation. In fact, the Notice To Co-Signer document is currently required by law to be replicated in Spanish in one state: California.

The benefit of having Spanish-language forms is obvious: you are offering a service to the over 30 million Spanish-speaking individuals who live in the United States. And with Spanish being the most widely taught foreign language in the United States, your credit union is likely to have a few employees who speak fluently.

One thing to keep in mind is that verbal transactions should, and many times must, be followed with written documentation. If you have had to turn down Spanish-speaking prospective members in the past, you can add to your potential membership from this growing population, starting with Spanish-language membership applications. And if your credit union has its own marketing materials, or needs print marketing materials to be created by Oak Tree, they can also be translated in order to reach out to the Spanish community as an additional means of enticing these potential new members.

If you would like to know more about these services or anything else that Oak Tree can do for your credit union, please contact the sales department via our toll-free telephone number at (800) 537-9598 or via email at sales@oaktreebiz.com.

Check our Web site www.oaktreebiz.com for additional supplemental article(s) on regulatory requirements and how they affect your forms.

REFINING LENDING PRACTICES

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1/30/2011: Reg. Z (TILA)

MDIA interim final rule for mortgage loans with variable rates or payments

1/31/2011: Reg. E (EFTA)

Extension of compliance deadline for printed gift card disclosures

4/1/2011: Reg. Z (TILA)

Restrictions on loan steering and loan originator compensation

If you have any questions regarding any of this information, please feel free to contact Rod Terry. Oak Tree is proud to say that, for over ten years, we have had the benefit of having Rod's vast array of lending knowledge and expertise leading our Product Management department. Rod came to us with over 22 years of experience in lending with over half of that time being in a position responsible for compliance matters. As Director of Product Management, Rod's responsibilities include overseeing all writing of new lending and operational packages, writing of any changes or updates whether credit union or regulatory driven. He also spends a great deal of his time pouring over the regulations and preparing for upcoming regulatory changes in addition to providing the much needed compliance answers.