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February 16, 2009

To: Clients and Friends

From: David F. Dulock

Subject: Regulation Z Amendments – Sections 226.32 and 226.34 and new Section 226.35 (HOEPA Loans and Higher-Priced Mortgage Loans) effective October 1, 2009

On July 30, 2008, the Board of Governors of the Federal Reserve System ("Board") published in the *Federal Register* (pages 44522 – 44614) its final rule (the "final rule") amending Regulation Z and its Official Staff Interpretations in Supplement I to Regulation Z ("Interpretations"). This memorandum will address only that part of the final rule that amends Sections 226.32(d)(7), 226.34(a)(4), and adds new Section 226.35, which relate to HOEPA loans and higher-priced mortgage loans. These amendments become effective **October 1, 2009**, except for the property tax and insurance escrow requirement of Section 226.35(b)(3) (*see page 16 for an explanation*).

This is our final memorandum addressing the final rule amendments to Regulation Z. Previously we have issued the following memorandums addressing the final rule changes to Regulation Z: (i) on January 23, 2009, we issued a memorandum discussing new Section 226.36, which provides new protections for all closed-end loans secured by a consumer's principal dwelling; (ii) on January 16, 2009, we issued a memorandum discussing the final rule amendments to the advertising requirements of Section 226.16 and 226.24; and, (iii) on January 9, 2009, we issued a memorandum discussing the final rule amendments to the early disclosure requirements of Section 226.19(a)(1). All of these memorandums may be viewed on the *what's new?* page of our website: http://www.bmandg.com.

Text of the Final Rule:

The text of the final rule can be printed from the *Federal Register* website by clicking on: http://edocket.access.gpo.gov/2008/pdf/E8-16500.pdf.

The amendments to Sections 226.32(d)(7), 226.34(a)(4), and new Section 226.35 are in the above issue of the *Federal Register* on pages 44603 – 44604. Their Official Staff Interpretations are in the above issue of the *Federal Register* on pages 44610 – 44613.

Overview of the HOEPA Loan and Higher-Priced Mortgage Loan Amendments:

(*This overview of the amendments is taken from the Board's July 14, 2008 press release and the Board's* SUMMARY *starting on page 44522 of the above referenced issue of the Federal Register.)*

1. <u>HOEPA Loans</u>: The final rule amends the prepayment penalty provisions in Section 226.32(d)(7) and amends the repayment ability requirements in Section 226.34(a)(4).

2. <u>Higher-Priced Mortgage Loans</u>: The final rule includes a newly defined category of closed-end loans secured by a consumer's principal dwelling, called a "higher-priced mortgage loan," that will cover virtually all subprime loans and some alt-A loans but generally exclude loans in the prime market. In order to determine if a loan is a higher-priced mortgage loan, the Board will publish an index defined as the "average prime

offer rate," which will be based on the Freddie Mac Primary Mortgage Market Survey® currently published by Freddie Mac. A loan is a higher-priced mortgage loan if it is a first lien mortgage secured by a consumer's principal dwelling and has an annual percentage rate (APR) that is 1.5 percentage points or more above this index, or if it is a subordinate lien mortgage secured by a consumer's principal dwelling and has an APR that is 3.5 percentage points or more above this index. The final rule adds four protections for a higher-priced mortgage loan:

(1) Prohibits a creditor from making a loan without regard to a borrower's ability to repay the loan from income and assets other than the home's value. A creditor complies, in part, by assessing repayment ability based on the highest scheduled payment in the first seven years of the loan. To show that a creditor violated this prohibition, a borrower no longer needs to demonstrate that it is part of a "pattern or practice" as is currently required by existing Section 226.34(a)(4).

(2) Requires a creditor to verify the income and assets it relies upon to determine repayment ability, thereby prohibiting a creditor from relying on income or assets that it does not verify to determine repayment ability.

(3) A prepayment penalty period cannot last for more than two years after consummation, and bans any prepayment penalty if the periodic payment can change in the initial four years.

(4) Requires a creditor to establish an escrow account for property taxes and homeowner's and mortgage default insurance for a first lien higher-priced mortgage loan. The creditor may permit the borrower, upon written request, to cancel the escrow account after one year.

Summary of the HOEPA Loan and Higher-priced Mortgage Loan Amendments:
(*This summary of the amendments is taken from the* SUPPLEMENTARY INFORMATION section *(pages 44531- 44563 of the above referenced issue of the Federal Register.*)

1. HOEPA Loan Amendments – Sections 226.32 and 226.34

A. Overview:

The Home Ownership and Equity Protection Act (HOEPA) imposes substantive restrictions and special pre-closing disclosures on certain high-cost refinance and home equity loans ("HOEPA loans"). These restrictions include limitations on prepayment penalties and balloon payments, and prohibitions of negative amortization and of engaging in lending based on the collateral without regard to the consumer's repayment ability. HOEPA loans are closed-end, non-purchase money mortgages secured by a consumer's principal dwelling (other than a reverse mortgage) where either: (a) the APR at consummation will exceed the yield on Treasury securities of comparable maturity by more than 8 percentage points for first lien loans, or 10 percentage points for subordinate lien loans; or (b) the total points and fees payable by the consumer at or before closing exceed the greater of 8 percent of the total loan amount, or $400 adjusted annually (*i.e.*, $583 for 2009). Sections 226.31, 226.32, and 226.34 of Regulation Z implement the requirements of the HOEPA and specifically govern HOEPA loans.

B. Prepayment Penalties – Amended Section 226.32(d)(7):

Existing Section 226.32(d)(6) prohibits a prepayment penalty in connection with a HOEPA loan except as allowed under Section 226.32(d)(7). The final rule amends subsection 32(d)(7)(i) to reduce the period in which a prepayment penalty is permitted on a HOEPA loan from five years to two years following consummation. It also amends subsection 32(d)(7)(iii) to change the requirement to verify the consumer's monthly debt-to-income ratio at consummation from verification "by the consumer's signed financial statement, a credit report, and payment records for employment income" to verification "in accordance with [Subsection] 226.34(a)(4)(ii)." Lastly, the final rule adds new subsection 32(d)(7)(iv) to state, "The amount of the periodic payment of principal or interest or both may not change during the four-year period following consummation."

See section **3.** of this memorandum for a discussion of the amendments to Section 226.32(d)(7) summarized above (which also apply to higher-priced mortgage loans subject to new Section 226.35).

C. Consumer's Ability to Repay - Amended Section 226.34(a)(4):

Section 226.34(a)(4) currently prohibits a lender from engaging in "a pattern or practice" of extending HOEPA loans based on the consumer's collateral without regard to the consumer's repayment ability, including the consumer's current and expected income, current obligations, and employment. Section 226.34(a)(4) also currently provides that a creditor is presumed to have violated this prohibition if it engages in "a pattern or practice" of failing to verify repayment ability. The final rule removes the "pattern or practice" qualification from Section 226.34(a)(4), thereby prohibiting a creditor from extending any individual HOEPA loan (as well as any higher-priced mortgage loan – *see section **2.** of this memorandum*) based on the collateral without regard to repayment ability. The final rule revises Section 226.34(a)(4) - see revised Section 226.34(a)(4) below - to provide that repayment ability is determined according to current and reasonably expected income, employment, assets other than the collateral, current obligations, and mortgage-related obligations (*see Subsection 226.34(a)(4)(i)*). The final rule removes the presumption of violation for failing to verify repayment ability and makes verification of repayment ability an explicit requirement (*see Subsection 226.34(a)(4)(ii)*). The final rule adds a presumption of compliance that specifies three underwriting procedures to follow (*see Subsection 226.34(a)(4(iii)*) and an exclusion from a presumption of compliance for certain negative amortization and balloon transactions (*see Subsection 226.34(a)(4)(iv)*). Section 226.34(a)(4) provides that a creditor shall not:

> (4) *Repayment ability*. Extend credit subject to Section 226.32 to a consumer based on the value of the consumer's collateral without regard to the consumer's repayment ability as of consummation, including the consumer's current and reasonably expected income, employment, assets other than the collateral, current obligations, and mortgage-related obligations.
>
> (i) *Mortgage-related obligations*. For purposes of this paragraph (a)(4), mortgage-related obligations are expected property taxes, premiums for mortgage-related insurance required by the creditor as set forth in Section 226.35(b)(3)(i), and similar expenses.
>
> (ii) *Verification of repayment ability*. Under this paragraph (a)(4) a creditor must verify the consumer's repayment ability as follows:

> (A) A creditor must verify amounts of income or assets that it relies on to determine repayment ability, including expected income or assets, by the consumer's Internal Revenue Service Form W-2, tax returns, payroll receipts, financial institution records, or other third-party documents that provide reasonably reliable evidence of the consumer's income or assets.
> (B) Notwithstanding paragraph (a)(4)(ii)(A), a creditor has not violated paragraph (a)(4)(ii) if the amounts of income and assets that the creditor relied upon in determining repayment ability are not materially greater than the amounts of the consumer's income or assets that the creditor could have verified pursuant to paragraph (a)(4)(ii)(A) at the time the loan was consummated.
> (C) A creditor must verify the consumer's current obligations.
> (iii) *Presumption of compliance*. A creditor is presumed to have complied with this paragraph (a)(4) with respect to a transaction if the creditor:
> (A) Verifies the consumer's repayment ability as provided in paragraph (a)(4)(ii);
> (B) Determines the consumer's repayment ability using the largest payment of principal and interest scheduled in the first seven years following consummation and taking into account current obligations and mortgage-related obligations as defined in paragraph (a)(4)(i); and
> (C) Assesses the consumer's repayment ability taking into account at least one of the following: The ratio of total debt obligations to income, or the income the consumer will have after paying debt obligations.
> (iv) *Exclusions from presumption of compliance*. Notwithstanding the previous paragraph, no presumption of compliance is available for a transaction for which:
> (A) The regular periodic payments for the first seven years would cause the principal balance to increase; or
> (B) The term of the loan is less than seven years and the regular periodic payments when aggregated do not fully amortize the outstanding principal balance.
> (v) Exemption. This paragraph (a)(4) does not apply to temporary or "bridge" loans with terms of twelve months or less, such as a loan to purchase a new dwelling where the consumer plans to sell a current dwelling within twelve months.

While Section 226.34(a)(4) governs the process for extending credit, it does not dictate which types of credit or credit terms are permissible and which are not. It does not prohibit potentially riskier types of loans such as loans with balloon payments, loans with interest-only payments, or ARMs with discounted initial rates. It merely prohibits a creditor from extending such products or other HOEPA or higher-priced mortgage loans without adequately evaluating repayment ability. Section 226.34(a)(4) explicitly requires that the creditor verify income and assets using reliable third party documents and, therefore, prohibits relying merely on an income statement from the applicant (*see Subsection 226.34(a)(4)(ii)(A)*). In addition, Section 226.34(a)(4) requires assessing not just the consumer's ability to pay loan principal and interest, but also the consumer's ability to pay property taxes, homeowner's insurance, and similar mortgage-related expenses.

The phrase "as of consummation" is added to Section 226.34(a)(4) to make clear that the prohibition is based on the facts and circumstances known to the creditor as of consummation. For example, comment 34(a)(4)-5 of the Interpretations provides that if a consumer's written application states that the consumer plans to retire or transition from full-time to part-time employment, the creditor is required to consider that information; but, a creditor does not violate

Section 226.34(a)(4) if a consumer defaults because of significant income losses or expenses that occur after consummation (*e.g.*, job loss or major medical expense).

Existing Section 226.34(a)(4) prohibits a creditor from making a HOEPA loan "without regard to the consumer's repayment ability, including the consumer's current and expected income, current obligations, and employment." Section 226.34(a)(4), as revised by the final rule, expands the sources of repayment ability to include "the consumer's current and reasonably expected income, employment, assets other than the collateral, current obligations, and mortgage-related obligations." **(emphasis added)** Comment 34(a)(4)-2 of the Interpretations clarifies that a creditor may determine a consumer's repayment ability based on current or reasonably expected income from employment, or other sources, or on assets other than the collateral, or on both income and assets. In its preamble published in the *Federal Register* with the final rule, the Board states that a creditor who determines repayment ability based on information other than income or assets must clearly show that this information establishes repayment ability; but the consumer's credit score or the collateral's loan-to-value ratio are not the type of other information considered adequate to establish repayment ability.

Revised Section 226.34(a)(4) provides broad flexibility as to the types of income, assets, and employment a creditor may rely on. Comment 34(a)(4)-6 of the Interpretations provides the following specific examples: current or expected salary, wages, bonuses, tips, and commissions; employment that is full-time, part-time, seasonal, irregular, military, or self-employment; income such as interest, dividends, retirement benefits, public assistance, alimony, child support, and separate maintenance payments; assets such as savings accounts and investments. The Board states in the final rule's preamble that these examples are merely illustrative, not exhaustive. As stated above, revised Section 226.34(a)(4) and its Interpretations permit a lender to rely on expected income and employment, not just current income and employment. Comment 34(a)(4)(ii)-3 of the Interpretations provides that expectations for improvements in income or employment must be reasonable and verified with third party documents that bear out that reasonable expectation. It also gives as examples, expected bonuses verified with documents demonstrating past bonuses and expected employment verified with a commitment letter from the future employer stating a specified salary.

Revised Section 226.34(a)(4) retains the reference to current obligations. Comment 34(a)(4)-3 of the Interpretations clarifies that Section 226.34(a)(4) makes a creditor responsible for considering only those current or simultaneous obligations of which the creditor has knowledge. For example, the term includes an obligation (of which the creditor has knowledge) secured by the consumer's primary dwelling undertaken prior to or contemporaneously with the creditor's HOEPA or higher-priced mortgage loan on that dwelling.

Subsection 34(a)(4)(v) exempts temporary or bridge loans with terms of 12 months or less from the requirements of Section 226.34(a)(4). Construction only loans, reverse mortgage loans and HELOC loans are already exempt (*see existing Section 226.32(a)(2*). The Board states, however, in the preamble published with the final rule that it expects this bridge loan exception to be applied narrowly and not for the purpose of evading or circumventing Section 226.34(a)(4), such as by structuring a 12-month loan with a substantial balloon payment in order to induce a consumer to refinance repeatedly into a series of 12-month loans.

Notwithstanding the above requirements, comment 34(a)(4)-7 of the Interpretations explains that Section 226.34(a)(4) does not require or permit a creditor to make inquires or verifications prohibited by Regulation B of ECOA.

D. Verification of Repayment Ability - Subsection 226.34(a)(4)(ii):

Currently Section 226.34(a)(4) contains a presumption of a violation when a creditor engages in a pattern or practice of making HOEPA loans without verifying and documenting the consumers' repayment ability. As subsection **1.***C.* of this memorandum explains, the final rule revises Section 226.34(a)(4) by removing the pattern or practice element, making verifying repayment ability an affirmative requirement, removing the failure to verify as a presumption of a violation, and explicitly applying the verification requirement to current obligations (*see Subsections 226.34(a)(4)(ii)(A) and (C)*). Subsection 226.34(a)(4)(ii)(A) requires creditors to verify income or assets (including expected income or assets) using third-party documents that provide reasonably reliable evidence of the income or assets relied on (*e.g*., W-2s, tax returns, payroll receipts, and financial institution records). Thus, according to the Board's preamble published with the final rule, revised Section 226.34(a)(4) would rarely, if ever, permit a creditor to make even isolated "no income, no asset" HOEPA or higher-priced mortgage loans. The creditor, however, need only verify and document the income or assets relied on in verifying repayment ability. For example, comment 34(a)(4)(A)(ii)-1 of the Interpretations provides that if the consumer receives a salary and a bonus, but the creditor relies only on the salary to verify repayment ability, the creditor need only verify the salary and may disregard verifying the bonus. And, comment 34(a)(4)(A)(ii)-2 of the Interpretations provides that if there are co-applicants and the creditor relies only on the income or assets of one co-applicant in determining repayment ability, the creditor need not verify the repayment ability of both applicants. Similarly, as the Board states in its preamble, the creditor may verify an amount of income or assets less than that stated in the loan file if the lesser amount is adequate to determine the consumer's repayment ability. Also, as stated in comment 34(a)(4)(ii)-3 of the Interpretations, the creditor may rely on expected income or assets, so long as the expectation is reasonable and verified with third party documents that provide reasonably reliable evidence.

As noted above, Subsection 226.34(a)(4)(ii)(A) provides that the creditor must verify the consumer's income or assets the creditor relies on by the consumer's W-2 forms, tax returns, payroll receipts, financial institution records, or other third party documents that provide reasonably reliable evidence in this regard. The Board's preamble published with the final rule states that W-2 forms, tax returns, payroll receipts, and financial institution records are sufficiently reliable sources; that, for this reason, Subsection 226.34(a)(4)(ii)(A) provides a safe harbor for their use; and that most consumers should have little difficulty in producing one of these documents. The Board further states that, for other consumers, Subsection 226.34(a)(4)(ii)(A) permits a creditor to rely on any third party document that provides reasonably reliable evidence of the income or assets relied on to determine repayment ability. We believe that these preamble statements by the Board imply that for consumers for which W-2 forms, tax returns, payroll receipts, or financial institution records can be obtained, these documents must be the source of verification. Please note, however, that the text of Subsection 226.34(a)(4)(ii)(A) and its Interpretations do not lend themselves to this implication.

In addition to verification of a consumer's income or assets by use of the consumer's individual W-2 or tax return, comments 34(a)(4)(ii)(A)-1 and –2 of the Interpretations permit

verification by use of an electronic retrieval service for obtaining W-2 or tax return information. Comment 34(a)(4)(ii)(A)–2 also permits the creditor to use those IRS Forms appropriate for obtaining tax return information directly from the IRS (*e.g.*, Forms 4506, 4506-T, or 8821).

As for "other third party documents that provide reasonably reliable evidence of the consumer's income or assets," comment 34(a)(4)(ii)(A)-3 of the Interpretations provides the following examples (*which are only illustrative and not limiting*): (i) statements from the consumer's employer (including by letter or email) stating the consumer's income, but not information provided orally by a third party; and, (ii) receipts from a check-cashing or remittance service. And, according to the Board's preamble statements, third party documentation the consumer provides directly to the creditor are permitted, but written statements only from the consumer are prohibited.

Comment 34(a)(4)(ii)(A)-5 of the Interpretations provides that a creditor who has previously extended credit to a consumer, and is refinancing or extending new credit to that consumer, is not required to re-collect a document on the consumer the creditor previously collected if the creditor reasonably believes, based on current information, that the document has not changed.

According to the Board's preamble, the final rule allows for flexibility in verifying a self-employed consumer's income or assets so long as the creditor complies with Section 226.34(a)(4). For example, Subsection 226.34(a)(4)(ii)(A) and its Interpretations do not dictate how many years of tax returns or other information a creditor must review to determine a self-employed consumer's repayment ability, or which income figure on the tax returns the creditor must use. Likewise, the final rule is flexible as to consumers who depend on bonuses and commissions. For example, if a consumer states that he or she may or will receive an annual bonus of a certain amount, the creditor can verify the statement with third party documents showing a consumer's past annual bonuses. (*See comment 34(a)(4)(ii)–3 above.*) Similarly, according to the Board's preamble, for a consumer who works on commission, the creditor can verify that with third party documents showing past commissions.

Subsection 226.34(a)(4)(ii)(B) provides an affirmative defense for a creditor who fails to comply with the verification requirements of Subsection 226.34(a)(4)(ii)(A), if the creditor demonstrates that the amounts of the consumer's income or assets the creditor relied on are not materially greater than what the creditor could have documented at consummation. According to the Board's preamble statements, this defense is not a safe harbor for non-compliance; rather, the defense is available only where the creditor can show that the amounts of income and assets relied on are not materially greater than the amounts the creditor could have verified. The phrase "materially greater than" is not based on a numerical threshold; rather, comment 34(a)(4)(ii)(B)-2 of the Interpretations states, "[a]mounts of income or assets relied on are not materially greater than amounts that could have been verified at consummation if relying on the verifiable amounts would not have altered a reasonable creditor's decision to extend credit or the terms of the credit."

Subsection 226.34(a)(4)(ii)(C) requires the creditor to verify the consumer's current obligations as part of verifying the consumer's repayment ability. Comment 34(a)(4)(ii)(C)-1 of the Interpretations permits the creditor to use a credit report for this purpose and cautions that if the credit report does not reflect an obligation listed on the consumer's loan application, the

creditor must still take that obligation into consideration, but is not required to independently verify the obligation. Comment 34(a)(4)(ii)(C)-1 further states that, even if not reflected on the credit report, the creditor must consider an obligation (of which the creditor has knowledge) secured by the consumer's primary dwelling undertaken prior to or contemporaneously with the creditor's HOEPA or higher-priced mortgage loan on that dwelling (*see also comment 34(a)(4)-3 above*).

E. Presumption of Compliance – Subsection 226.34(a)(4)(iii):

Under Subsection 226.34(a)(4)(iii), a creditor is presumed to have complied with Section 226.34(a)(4) if the creditor: (1) verifies repayment ability (*Subsection 34(a)(4)(iii)(A)*); (2) determines the consumer's repayment ability using the largest scheduled payment of principal and interest in the first seven years following consummation, taking into account current and mortgage-related obligations (*Subsection 34(a)(4)(iii)(B)*); and (3) assesses the consumer's repayment ability using at least one of the following measures: (i) a ratio of total debt obligations to income, or (ii) the income the consumer will have after paying debt obligations (*Subsection 34(a)(4)(iii)(C)*). ***Note:*** Verifying repayment ability is mandated by Subsection 226.34(a)(4)(ii); however, the procedures in (2) and (3) above are not mandated – that is, they are voluntary, assuming a creditor wishes to be presumed in compliance with Section 226.34(a)(4). Comment 34(a)(4)(iii)-1 of the Interpretations states that this presumption can be rebutted, however, if the consumer furnishes evidence that the creditor disregarded repayment ability despite following the presumption procedures in Subsection 226.34(a)(4)(iii). Comment 34(a)(4)(iii)-1 also provides that if a creditor fails to follow one of the non-mandatory procedures set forth in Subsection 226.34(a)(4)(iii), then the creditor's compliance is determined based on all of the facts and circumstances without there being a presumption of either compliance or violation.

Subsection 226.34(a)(4)(iii)(B) sets out the payment that the creditor should use to determine repayment ability in order to have a presumption of compliance. For example, for a loan with a fixed rate and a fixed payment that fully amortizes the loan over its contractual term to maturity, the creditor will, of course, use the fixed rate and the fixed principal and interest payment; but, for a loan in which the rate and payment can change, the creditor will use the largest scheduled payment of principal and interest in the first seven years. Although Subsection 226.34(a)(4)(iii) provides that the creditor who uses the largest scheduled payment of principal and interest in the first seven years has a presumption of compliance, the creditor may use a lower payment, and no presumption of violation would attach; but, neither would a presumption of compliance. Instead, compliance would be determined based on all of the facts and circumstances. Furthermore, nothing in the final rule prohibits, or creates a presumption against, loans that are designed for consumers who legitimately expect to sell or refinance sooner than seven years.

Comment 34(a)(4)(iii)-1 of the Interpretations states that, in general, creditors should use the comments to Section 226.17(c)(1) for guidance in determining the largest scheduled principal and interest payment under Subsection 226.34(a)(4)(iii)(B), and gives examples for the following six loan products:

(i) Balloon payment loan with fixed interest rate (7-year term) – The loan has a 7-year term but is amortized over 30 years. If the creditor assesses repayment ability based on the loan's

regular principal and interest payment (not the balloon payment due at maturity), the creditor retains the presumption of compliance.

(ii) Fixed rate loan with interest only payment for five years (30-year term) - After an initial 5-year period of interest only payments the payment is recast to fully amortize the loan over the remaining 25 years. The creditor retains the presumption of compliance only if the creditor assesses repayment ability based on the scheduled principal and interest payment that fully amortizes the principal balance over the remaining 25 years and not the interest only payment.

(iii) Fixed rate loan with interest only payment for seven years (30-year term) - After an initial 7-year period of interest only payments the payment is recast to fully amortize the loan over the remaining 23 years. The creditor may retain the presumption of compliance if it assesses repayment ability using the scheduled interest only payment.

(iv) Variable rate loan with discount for five years (30-year term) – For the first five years, the interest rate is fixed. After five years, the interest rate will adjust each year based on a specified index and margin ("fully adjusted rate"). The creditor retains the presumption of compliance if the creditor assesses repayment ability using the principal and interest payment based on the fully adjusted rate at consummation.

(v) Variable rate loan with discount for seven years (30-year term) - For the first seven years, the interest rate is fixed. After seven years, the interest rate will adjust each year based on a specified index and margin ("fully adjusted rate"). If the creditor assesses repayment ability based on the scheduled principal and interest payment during the first seven years, the creditor retains the presumption of compliance.

(vi) Step rate loan (30-year term) - To retain the presumption of compliance, the creditor must assess repayment ability based on the largest scheduled payment of principal and interest during the first seven years of the loan.

Subsection 226.34(a)(4)(iii)(C) provides that a creditor does not have a presumption of compliance unless the creditor also assesses the consumer's repayment ability using at least one of the following: the consumer's ratio of total debt obligations to income ("DTI ratio"), or the income the consumer will have after paying debt obligations ("residual income"). Thus, a creditor retains a presumption of compliance so long as at least one of these two measures is used. Please note that Subsection 226.34(a)(4)(iii)(C) does not set a quantitative threshold for either of these two measures. Also, comment 34(a)(4)(C)(iii)-1 of the Interpretations allows a creditor to look to widely accepted governmental (*e.g.*, FHA Handbook 4155.1) and non-governmental underwriting standards in determining whether a particular item is "income" or "debt."

F. Exclusions from Presumption of Compliance - Subsection 226.34(a)(4)(iv):

Subsection 226.34(a)(4)(iv) excludes two types of loans from the presumption of compliance. Under Subsection 34(a)(4)(iv)(A), loans with scheduled payments that would increase the principal balance (negative amortization) within the first seven years are excluded from the presumption of compliance. Under Subsection 34(a)(4)(iv)(B), no presumption of

compliance is available for a balloon payment loan with a term shorter than seven years. For these two types of loans, compliance is determined based on all of the facts and circumstances without a presumption of compliance or violation. Comments 34(a)(4)(iv)-1 and –2 of the Interpretations refer the creditor to other comments in the Interpretations for further guidance in interpreting Subsection 226.34(a)(4)(iv). In addition, comment 34(a)(4)(iv)-2 provides that for a creditor who is unconditionally obligated to renew a balloon payment loan at the consumer's option, or is obligated to renew subject to conditions within the consumer's control, the full term resulting from the renewal is the loan term for purposes of Subsection 34(a)(4)(iv)(B).

2. Higher-Priced Mortgage Loans — New Section 226.35

A. Overview:

With the addition of Section 226.35, the final rule creates a new class of loan, defined as a "higher-priced mortgage loan," secured by the consumer's principal dwelling and having an annual percentage rate (APR) that exceeds a defined measure of market rates (termed "average prime offer rates") by certain percentage thresholds, depending upon whether the loan is secured by a first lien or second lien on the dwelling. Under new Section 226.35, a higher-priced mortgage loan is subject to the following restrictions: (1) a creditor cannot extend credit based on the collateral's value without regard to the consumer's ability to repay from sources other than the collateral itself; (2) a creditor must verify a consumer's repayment ability; (3) prohibits prepayment penalties unless certain conditions are met; and (4) for a higher-priced mortgage loan secured by a first lien, requires a creditor to establish an escrow account for taxes and insurance, but permits a creditor to allow a consumer to cancel the escrow account no earlier than 365 days after loan consummation. In addition, Section 226.35 prohibits a creditor from structuring a higher-priced mortgage loan as a HELOC for the purpose of evading Section 226.35.

B. Types of Loans Covered:

Higher-priced mortgage loan is defined as a consumer credit transaction secured by the consumer's principal dwelling for which the APR exceeds the average prime offer rate (derived from the Freddie Mac Primary Mortgage Market Survey®) for a comparable transaction by at least 1.5 percentage points for first lien loans, or 3.5 percentage points for subordinate lien loans. The definition includes home purchase loans, refinance loans, and home equity loans. It excludes HELOCs, reverse mortgages, construction only loans, and bridge loans (*see section **1.**C. above*). The definition appears in Section 226.35(a) and higher-priced mortgage loans are subject to the restrictions and requirements in Section 226.35(b) concerning repayment ability, income verification, prepayment penalties, and escrow accounts for taxes and insurance (*subordinate lien higher-priced mortgage loans are not subject to the escrow account requirement*).

C. Definitions – Sections 226.35(a)(1) and (a)(2):

Section 226.35(a)(1) defines a consumer credit transaction secured by the consumer's principal dwelling as a higher-priced mortgage loan if its APR exceeds the average prime offer rate for a comparable transaction by 1.5 percentage points for first lien loans, or 3.5 percentage points for subordinate lien loans, using the most recently available average prime offer rate as of the date the creditor sets the loan's interest rate for the final time before consummation.

Section 226.35(a)(2) defines an "average prime offer rate" as an APR derived from average interest rates, points, and other pricing terms offered by a representative sample of creditors for mortgage transactions that have low-risk pricing characteristics.

D. Primary Mortgage Market Survey®:

Section 226.35(a)(2) and its Interpretations provide that the Board will derive average prime offer rates from survey data according to a methodology it will make publicly available, and publish these rates in a table on the Internet on at least a weekly basis. This table will indicate how to identify a comparable transaction. As noted above, the survey the Board intends to use for the foreseeable future is the Freddie Mac Primary Mortgage Market Survey® (PMMS), which contains weekly average rates and points offered by a representative sample of creditors to prime borrowers seeking a first-lien, conventional, conforming mortgage (*i.e.*, eligible for purchase by Fannie Mae or Freddie Mac) and who would have at least 20 percent equity. The PMMS contains pricing data for four types of transactions: 1-year ARM, 5/1-year ARM, 30-year fixed, and 15-year fixed. For the two types of ARMs, PMMS pricing data are based on ARMs that adjust according to the yield on one-year Treasury securities; the pricing data include the margin and the initial rate (if it differs from the sum of the index and margin). These data are updated every week and are published on Freddie Mac's Web site:

See http://www.freddiemac.com/dlink/html/PMMS/display/PMMSOutputYr.jsp.

The PMMS does not contain pricing data for subordinate lien loans, although the Board will publish average prime offer rates for subordinate lien loans based on the data in the PMMS. This is based on the Board's realization that a suitable measure of market rates for subordinate lien loans does not exist.

If the PMMS ceases to be available, or if circumstances arise that render it unsuitable, the Board states in its preamble published with the final rule that it will consider other alternatives including conducting its own survey. The Board will use the pricing terms from the PMMS, such as interest rate and points, to calculate an APR (consistent with Section 226.22 of Regulation Z) for each of the four types of transactions that the PMMS reports. These APRs are the average prime offer rates for transactions of that type. The Board will estimate APRs for other types of transactions for which survey data is not available from the loan pricing terms available in the PMMS and other information. The methodology the Board uses will be published on the Internet along with the table of APRs.

E. Consumer's Ability to Repay - Sections 226.34(a)(4) and 226.35(b)(1):

The final rule extends to higher-priced mortgage loans the HOEPA prohibition against lending based on a consumer's collateral without regard to the consumer's repayment ability at consummation and the HOEPA requirement that the creditor verify the consumer's income, assets and obligations to determine repayment ability. Section 226.34(a)(4), which applies to HOEPA loans, is incorporated by reference into Section 226.35(b)(1) to be applicable to higher-priced mortgage loans. (*See Sections 1.C. and D. of this memorandum.*)

F. Escrow Requirement - Section 226.35(b)(3):

(1) Subsection 226.35(b)(3)(i) prohibits a creditor from making a higher-priced mortgage loan secured by a first lien unless, before consummation, an escrow account is established for property taxes and mortgage related insurance required by the creditor (*e.g.*, property or homeowners insurance, flood insurance, and/or mortgage default insurance). Comment 35(b)(3)(i)-2 of the Interpretations provides that RESPA's rules for administering escrow accounts (*i.e.*, Section 6 of RESPA and Regulation X) apply to this escrow account requirement.

(2) Subsection 226.35(b)(3)(ii)(A) exempts a higher-priced mortgage loan secured by shares in a cooperative from the escrow account requirement of Subsection 226.35(b)(3)(i); but, the Board's preamble states that this exemption only applies to a cooperative whose cooperative association (i) maintains adequate insurance coverage on the cooperative under a master policy, (ii) pays the property taxes and insurance premiums, and (iii) passes that cost on to the individual unit owners through the association's periodic dues for each unit.

(3) For a higher-priced mortgage loan secured by a condominium unit, Subsection 226.35(b)(3)(ii)(B) exempts insurance premiums from the escrow account requirement of Subsection 226.35(b)(3)(i) if the condominium association maintains the insurance through a master policy insuring the condominium units; but, the Board's preamble states that this exemption only applies (i) if the only insurance that the creditor requires is an association master policy that insures condominium units, and (ii) the condominium association pays the insurance premiums and passes that cost on to the individual unit owners through the association's periodic dues for each unit. According to comment 35(b)(3)(ii)(B)-1 of the Interpretations, for all first lien higher-priced mortgage loans secured by condominium units, Subsection 226.35(b)(3)(ii)(B) does not exempt property taxes from the escrow account requirement of Subsection 226.35(b)(3)(i).

(4) Under Subsection 226.35(b)(3)(iii), a creditor or servicer may allow a consumer to cancel the escrow account by a dated written request received no earlier than 365 days after consummation.

(5) Subsection 226.35(b)(3(iv) defines "escrow account" by reference to its definition in Section 3500.17(b) of Regulation X.

(6) Comment 35(b)(3)(i)-3 of the Interpretations clarifies that Section 226.35(b)(3)(i) does not require creditors and servicers to escrow premiums for optional mortgage-related insurance chosen by the consumer and not otherwise required by the creditor (*e.g.*, earthquake insurance or debt protection insurance).

(7) The Board's preamble published with the final rule states that the final rule neither permits nor prohibits creditors from imposing escrow cancellation fees in connection with the escrow account required by Subsection 226.35(b)(3)(i) and instead defers to state law on that issue. Similarly, the Board's preamble states that the final rule neither requires nor prohibits payment of interest on escrow accounts since some, but not all, states require creditors to pay interest to consumers for escrowed funds (*although, most states do not*).

G. *Evasion of Rule - Section 226.35(b)(4):*

Section 226.35(b)(4) prohibits a creditor from structuring a closed-end home loan as an open-end line of credit for the purpose of evading Section 226.35's restrictions on higher-priced mortgage loans (which do not apply to open-end lines of credit). In its preamble to the final rule, the Board states that Section 226.35(b)(4) is intended to prohibit a creditor from structuring a loan as an open-end line of credit when the loan's features and terms or other circumstances demonstrate that the creditor has no reasonable expectation of repeat transactions under a reusable line of credit. Although this practice already violates TILA, Section 226.35(b)(4) subjects a violating creditor to HOEPA's stricter remedies if the credit's APR exceeds Section 226.35's APR trigger for higher-priced mortgage loans. The Board states that it recognizes that a consumer may prefer an open-end line of credit to a closed-end home loan because of the added flexibility an open-end line of credit provides, and Section 226.35(b)(4) is not intended to limit a consumer's ability to choose between these two ways of structuring home equity credit.

3. Prepayment Penalties – Sections 226.32(d)(6) and (7); Section 226.35(b)(2)

(1) Section 226.32(d)(6) prohibits a prepayment penalty for HOEPA loans, except as allowed by Section 226.32(d)(7). Existing and revised Section 226.32(d)(7) contains the prepayment penalty rules for HOEPA loans. New Section 226.35(b)(2) contains substantially similar prepayment penalty prohibitions and rules for higher-priced mortgage loans.

For HOEPA loans, revised Section 226.32(d)(7) provides as follows:

> (7) *Prepayment penalty exception.* A mortgage transaction subject to this section may provide for a prepayment penalty (including a refund calculated according to the rule of 78s) otherwise permitted by law if, under the terms of the loan:
> (i) The penalty will not apply after the two-year period following consummation;
> (ii) The penalty will not apply if the source of the prepayment funds is a refinancing by the creditor or an affiliate of the creditor;
> (iii) At consummation, the consumer's total monthly debt payments (including amounts owed under the mortgage) do not exceed 50 percent of the consumer's monthly gross income, as verified in accordance with Section 226.34(a)(4)(ii); and
> (iv) The amount of the periodic payment of principal or interest or both may not change during the four-year period following consummation.

For higher-priced mortgage loans, new Section 226.35(b)(2) provides as follows:

> (2) *Prepayment penalties.* A loan may not include a penalty described by Section 226.32(d)(6) unless:
> (i) The penalty is otherwise permitted by law, including Section 226.32(d)(7) if the loan is a mortgage transaction described in Section 226.32(a); and
> (ii) Under the terms of the loan--
> (A) The penalty will not apply after the two-year period following consummation;
> (B) The penalty will not apply if the source of the prepayment funds is a refinancing by the creditor or an affiliate of the creditor; and
> (C) The amount of the periodic payment of principal or interest or both may not change during the four-year period following consummation.

(2) For HOEPA loans and higher-priced mortgage loans, the final rule prohibits prepayment penalties if the loan's periodic payments can change during the first four years following loan consummation (*see subsections 32(d)(7)(iv) and 35(b)(2)(ii)(C)*). For all other HOEPA loans and higher-priced mortgage loans (*i.e.*, loans whose periodic payments will not change during the first four years following consummation), the final rule limits the prepayment penalty period to two years after loan consummation (*existing Section 226.32(d)(7) presently limits the prepayment penalty for HOEPA loans to the first five years following consummation*) and also prohibits the application of a prepayment penalty if the same creditor or its affiliate refinances the loan (*the same* as *existing Section 226.32(d)(7) for HOEPA loans*). The Board states in the final rule's preamble that this prohibition applies even when the creditor no longer holds the loan at the time of a refinancing by the creditor or an affiliate of the creditor. For HOEPA loans, the final rule retains existing Section 226.32(d)(7)'s prepayment penalty prohibition when the consumer's verified DTI ratio at consummation exceeds 50 percent (*see subsection 32(d)(7)(iii)*). However, the final rule does not adopt this prohibition for higher-priced mortgage loans. ***Note**:* A recent unpublished U.S. 5th Circuit opinion, *Zeno v. Colonial Mortgage and Loan Corporation*, No. 08-CA-246, (Nov. 25, 2008) (2008 WL 5000136), held that the consumer's monthly gross income used to determine the DTI ratio does not include the income of the consumer's spouse who has no ownership interest in the home, did not apply for the loan, and is not obligated on the loan. (*At the time delivered, the opinion was subject to revision or withdrawal.*)

(3) According to the Board's preamble, the prepayment penalty prohibition in Subsections 32(d)(7)(iv) and 35(b)(2)(ii)(C) is not limited to loans where the periodic payment can increase but not decrease within four years; it applies to loans with potential payment changes within four years, including potential payment increases and potential payment decreases.

(4) Existing Subsection 32(d)(7)(iii) provides (when determining whether a prepayment penalty is prohibited on a HOEPA loan) that for purposes of determining whether at consummation a consumer's DTI ratio exceeds 50 percent, the consumer's income and expenses are to be verified by a financial statement signed by the consumer, by a credit report, and, in the case of employment income, by payment records. The final rule strengthens these standards by revising Subsection 32(d)(7)(iii) to require, instead, that creditors verify that the consumer's total monthly debt payments do not exceed 50 percent of the consumer's monthly gross income using the verification of repayment ability standards set forth in new Subsection 34(a)(4)(ii). (*See section **1.** D. of this memorandum.*)

(5) Under current footnote 48 to Section 226.23(a)(3), a HOEPA loan having a prepayment penalty that does not conform to the requirements of Section 226.32(d)(7) is subject to the consumer's three-year right to rescind set out in Section 226.23(a). As noted above, new Section 226.35(b)(2) contains prepayment penalty requirements for higher-priced mortgage loans that are substantially the same as the prepayment penalty requirements that revised Section 226.32(d)(7) applies to HOEPA loans. Accordingly, the final rule revises footnote 48 to provide that a higher-priced mortgage loan having a prepayment penalty that does not conform to the requirements of Section 226.35(b)(2) also is subject to the three-year right of rescission set out in Section 226.23(a). This right of rescission, however, does not extend to residential mortgage transactions (*i.e.*, loans for acquisition or initial construction of a principal dwelling), or certain refinancings with the same creditor (*see existing Section 226.23(f)*).

(6) As discussed above, the final rule sets forth the prepayment penalty rules in two separate sections of Regulation Z. For HOEPA loans, Section 226.32(d)(7) lists the conditions that must be met for the general prepayment penalty prohibition in Section 226.32(d)(6) not to apply. For higher-priced mortgage loans, Section 226.35(b)(2) prohibits a prepayment penalty unless the conditions in Subsections 35(b)(2) (i) and (ii) are met. To ensure consistent interpretation of these separate prepayment penalty sections, the Interpretations to Section 226.35(b)(2) cross-reference the applicable payment change examples and exclusions in the Interpretations to Section 226.32(d)(7).

(7) Comment 32(d)(7)(iii)-1 of the Interpretations explains that for the purposes of calculating the consumer's debt-to-income ratio required by Subsection 32(d)(7)(iii), "debt" does not include amounts paid by the consumer in cash at closing or amounts from the loan proceeds that directly repay an existing debt, and that creditors may consider combined debt-to-income ratios for transactions involving joint applicants. Comment 32(d)(7)(iii)-1 refers creditors to comment 34(a)(4)-6 and comment 34(a)(4)(iii)(C)-1, discussed in sections **1.***C.* and **1.***E.* of this memorandum, for more information about items that may constitute "debt" or "income" for purposes of Subsection 32(d)(7)(iii).

(8) Notwithstanding the requirement of Subsection 32(d)(7)(iii) that the creditor must verify the consumer's monthly gross income in accordance with Subsection 34(a)(4)(ii), comment 32(d)(7)(iii)-3 of the Interpretations explains that it does not require or permit a creditor to make inquires or verifications prohibited by Regulation B of ECOA.

(9) Comment 32(d)(7)(iv)-2 of the Interpretations states that the periodic payment change set out in Subsection 32(d)(7)(iv) does not include (i) a change in the amount of a periodic payment allocated to principal or interest that does not change the total amount of the periodic payment; (ii) a consumer's actual unanticipated late payment, delinquency, or default; and, (iii) a consumer's voluntary payment of additional amounts (*e.g.*, when a consumer makes a payment of interest and principal on a loan that only requires the payment of interest).

4. <u>Overlapping Coverage Applicable to HOEPA and Higher-Priced Mortgage Loans</u>

A. Exemptions:

Comment 32(a)(2)-1 of the Interpretations explains that although Section 226.32(a)(2) lists certain transactions exempt from the provisions of Section 226.32 (*i.e.*, residential mortgage transaction, reverse mortgage, and HELOC); nevertheless, residential mortgage transactions that are higher-priced mortgage loans subject to the provisions of Section 226.35 will be subject to the provisions of Section 226.32 to which Section 226.35 refers. *See* Section 226.35(a).

B. Additional Prohibitions:

Section 226.34 sets forth certain prohibitions in connection with HOEPA loans, in addition to the limitations in Section 226.32(d); and, Section 226.35(b) prohibits certain practices in connection with higher-priced mortgage loans. Comment 32(d)-1 of the Interpretations states that because the coverage test in Section 226.35(a) for higher-priced mortgage loans is generally broader than the coverage test in Section 226.32(a) for HOEPA loans, most HOEPA loans are also subject to the prohibitions set forth in Section 226.35(b), in addition to the limitations in

Section 226.32(d). For example, HOEPA loans are subject to the escrow account requirements of Section 226.35(b)(3). (*See section 2.F. of this memorandum.*)

Effective Dates for the Final Rule Amendments Discussed in this Memorandum:

Except as noted below, the final rule is effective for all written applications received by a creditor on or after **October 1, 2009**:

(1) The requirement to establish escrow accounts for higher-priced mortgage loans (*see section 2.F. of this memorandum*) is effective for all written applications received by the creditor on or after **April 1, 2010**, except for higher-priced mortgage loans secured by manufactured housing.

(2) The requirement to establish escrow accounts for higher-priced mortgage loans secured by manufactured housing is effective for all written applications received by the creditor on or after **October 1, 2010**. *Note:* The final rule applies to manufactured housing whether or not state law treats it as personal or real property.

Conclusion:

For those creditors engaged in subprime and alt-A lending, the amendments to Regulation Z discussed above will require these creditors, during the pre-closing process, to implement additional procedures to detect higher-priced mortgage loans and to engage in more extensive repayment verification procedures for HOEPA loans and these new higher-priced mortgage loans. In addition, they will require document and servicing changes regarding the assessment of prepayment penalties and the establishment of escrow account servicing procedures.

This Memorandum is provided for the general information of the clients and friends of our firm only and is not intended as specific legal advice. You should not place reliance on this general information alone but should consult legal counsel regarding the application of the information discussed in this Memorandum to your specific case or circumstances.