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To: Clients and Friends

From: David F. Dulock

Subject: Regulation Z APR Threshold for Required Escrow Account Increased for
“Jumbo” Loans – New Section 226.35(b)(3)(v) effective April 1, 2011

Finally, some good news from the Federal Reserve Board (FRB). In today’s issue of the *Federal Register* (76 FR 11319), the FRB published a final rule establishing a higher APR threshold for “jumbo” first lien, higher-priced mortgage loans in regard to the escrow account requirements implemented by §226.35(b)(3) of Regulation Z.

The final rule implements subsection (b) of section 129D of TILA (*section 129D was enacted as section 1461 of the Dodd-Frank Wall Street Reform and Consumer Protection Act*) by increasing the APR threshold used to determine whether a mortgage lender is required to establish an escrow account for property taxes and insurance for first lien, higher-priced “jumbo” mortgage loans. Jumbo loans are loans exceeding the conforming loan-size limit for purchase by Freddie Mac, as established and adjusted by the Federal Housing Finance Agency (FHFA). (*See* Freddie Mac Bulletin No. 2010-28 at: <http://www.freddiemac.com/sell/guide/bulletins/pdf/bl11028.pdf>.)

As you already know, in July 2008, the FRB issued final rules requiring creditors to establish escrow accounts for closed-end, first-lien, higher-priced mortgage loans (*See our memoranda of July 14, 2008, and February 16, 2009 at page 12*). A first lien mortgage is considered a higher-priced mortgage loan if the APR is 1.5% or more above the current average prime offer rate. Under the final rule published by the FRB today, the escrow account requirement will apply to first lien jumbo loans only if the loan’s APR is 2.5% or more above the average prime offer rate. The APR threshold for non-jumbo first lien, higher-priced mortgage loans remains unchanged. As does the APR threshold for subordinate lien higher-priced mortgage loans.

For example, the 2011 Freddie Mac maximum mortgage loan limit for a single-family property that is not located in a Freddie Mac designated “high cost” area is \$417,000. Thus, if in 2011 the original principal mortgage amount secured by a first lien on a single-family principal dwelling property not in a “high-cost” area is \$417,000 or less, the determination of whether the loan is subject to the escrow requirement in §226.35(b)(3) would be made using the existing APR threshold of 1.5% over the applicable average prime offer rate; but, if in 2011 the original principal mortgage amount is more than \$417,000 (*e.g.*, \$417,001 or greater), the determination would be made using an APR threshold of 2.5% over the applicable average prime offer rate. Likewise, the new 2.5% threshold applies to first lien principal dwelling property loans with original principal mortgage amounts in excess of the higher maximum mortgage loan limits applicable to two-to-four residential properties and those properties in designated high cost areas that are eligible for purchase by Freddie Mac. For example, if the maximum mortgage loan limit for a loan eligible for purchase by Freddie Mac in a particular “high cost” area is \$500,000 for a single-family property, then a loan with an

original principal mortgage amount secured by a first lien on a single-family principal dwelling property in that “high cost” area that is \$500,000 or less is not a jumbo loan and the determination of whether the loan is subject to the escrow requirement in §226.35(b)(3) would be made using the existing APR threshold of 1.5% over the applicable average prime offer rate. But, if the original principal mortgage amount were greater than \$500,000, then the determination would be made using an APR threshold of 2.5% over the applicable average prime offer rate.

Since loans that are too large to be eligible for purchase by Freddie Mac are generally referred to in the mortgage lending industry as “jumbo” loans, this term is used in the final rule to refer to these loans.

The new Official Staff Commentary portion of the final rule clarifies, however, that since the FHFA establishes and adjusts, from time to time, the conforming loan-size limit for loans eligible for purchase by Freddie Mac, these conforming loan-size limit adjustments made by the FHFA, from time to time, will apply in determining whether a loan is a jumbo loan subject to the final rule’s higher 2.5% threshold (*see* new comment 35(b)(3)(v)-1 below). In addition, new comment 35(b)(3)(v)-2 below clarifies that the 2.5% threshold applies only in determining if a jumbo loan is subject to the escrow account requirement of §226.35(b)(3). The determination of whether a jumbo loan is subject to the other requirements of §226.35 (*i.e.*, assessing the consumer’s repayment ability and prepayment penalty restrictions) will continue to be based on the 1.5% threshold.

The final rule allows creditors, if they so choose, to continue escrow accounts for jumbo loans with an APR below the 2.5% threshold (subject to applicable state or local laws that prohibit or regulate mandatory escrow accounts). Further, the final rule does not require termination of any existing escrow accounts for closed jumbo loans with an APR below the new threshold.

Section 226.35 is amended by revising paragraph (a)(1) [*revision is underlined*] and adding new paragraph (b)(3)(v) to read as follows:

§ 226.35 Prohibited acts or practices in connection with higher-priced mortgage loans.

(a) *Higher-priced mortgage loans*—(1) For purposes of this section, except as provided in paragraph (b)(3)(v) of this section, a higher-priced mortgage loan is a consumer credit transaction secured by the consumer’s principal dwelling with an annual percentage rate that exceeds the average prime offer rate for a comparable transaction as of the date the interest rate is set by 1.5 or more percentage points for loans secured by a first lien on a dwelling, or by 3.5 or more percentage points for loans secured by a subordinate lien on a dwelling.

(b)(3)(v) “*Jumbo*” loans. For purposes of this §226.35(b)(3), for a transaction with a principal obligation at consummation that exceeds the limit in effect as of the date the transaction’s interest rate is set for the maximum principal obligation eligible for purchase by Freddie Mac, the coverage threshold set forth in paragraph (a)(1) of this section for loans secured by a first lien on a dwelling shall be 2.5 or more percentage points greater than the applicable average prime offer rate.

The Official Staff Interpretations in Supplement I to Regulation Z are amended as follows:

A. Under Section 226.1, new paragraph 1(d)(5)-1.iii is added to read as follows:

1. *Effective dates.*

iii. The final rule revising escrow requirements under §226.35(b)(3) published on March 2, 2011 applies to certain closed-end extensions of consumer credit secured by the consumer's principal dwelling. *See* §226.35(a). Covered transactions for which an application is received by a creditor on or after April 1, 2011 are subject to §226.35(b)(3), as revised.

B. Under Section 226.35, new heading 35(b)(3)(v) “Jumbo” loans and new paragraphs 1 and 2 are added as follows:

35(b)(3) Escrows.

35(b)(3)(v) “Jumbo” loans.

1. *Special threshold for “jumbo” loans.* For purposes of the escrow requirement in §226.35(b)(3) only, the coverage threshold stated in §226.35(a)(1) for first-lien loans (1.5 or more percentage points greater than the average prime offer rate) does not apply to a loan with a principal obligation that exceeds the limit in effect as of the date the loan's rate is set for the maximum principal obligation eligible for purchase by Freddie Mac (“jumbo” loans). The Federal Housing Finance Agency (FHFA) establishes and adjusts the maximum principal obligation pursuant to 12 U.S.C. 1454(a)(2) and other provisions of federal law. Adjustments to the maximum principal obligation made by FHFA apply in determining whether a mortgage loan is a “jumbo” loan to which the separate coverage threshold in §226.35(b)(3)(v) applies.

2. *Escrow requirements only.* Under §226.35(b)(3)(v), for “jumbo” loans, the annual percentage rate threshold is 2.5 or more percentage points greater than the average prime offer rate. This threshold applies solely in determining whether a “jumbo” loan is subject to the escrow requirement of §226.35(b)(3). The determination of whether “jumbo” first-lien loans are subject to the other protections in §226.35, such as the ability to repay requirements under §226.35(b)(1) and the restrictions on prepayment penalties under §226.35(b)(2), is based on the 1.5 percentage point threshold stated in §226.35(a)(1).

The final rule is effective for covered jumbo loans for which the creditor receives an application on or after April 1, 2011.

This memorandum is for informational purposes only and we advise you to read the final rule and the FRB preamble published with the final rule in the March 2, 2011 Federal Register at the following website: <http://www.gpo.gov/fdsys/pkg/FR-2011-03-02/pdf/2011-4384.pdf>.

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