Regulation Z

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

(a) Higher-priced mortgage loans--(1) For purposes 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.

(2) ``Average prime offer rate'' means an annual percentage rate that is derived from average interest rates, points, and other loan pricing terms currently offered to consumers by a representative sample of creditors for mortgage transactions that have low-risk pricing characteristics. The Board publishes average prime offer rates for a broad range of types of transactions in a table updated at least weekly as well as the methodology the Board uses to derive these rates.

(3) Notwithstanding paragraph (a)(1) of this section, the term ``higher-priced mortgage loan'' does not include a transaction to finance the initial construction of a dwelling, a temporary or ``bridge'' loan with a term 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, a reverse-mortgage transaction subject to Sec. 226.33, or a home equity line of credit subject to Sec. 226.5b.

(b) Rules for higher-priced mortgage loans. Higher-priced mortgage loans are subject to the following restrictions:

(1) *Repayment ability.* A creditor shall not extend credit based on the value of the consumer's collateral without regard to the consumer's repayment ability as of consummation as provided in Sec. 226.34(a)(4).

(2) *Prepayment penalties*. A loan may not include a penalty described by Sec. 226.32(d)(6) unless:

(i) The penalty is otherwise permitted by law, including Sec. 226.32(d)(7) if the loan is a mortgage transaction described in Sec. 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.

(3) *Escrows*--(i) *Failure to escrow for property taxes and insurance*. Except as provided in paragraph (b)(3)(ii) of this section, a creditor may not extend a loan secured by a first lien on a principal dwelling unless an escrow account is established before consummation for payment of property taxes and premiums for mortgage-related insurance required by the creditor, such as insurance against loss of or damage to property, or against liability arising out of the ownership or use of the property, or insurance protecting the creditor against the consumer's default or other credit loss.

(ii) *Exemptions for loans secured by shares in a cooperative and for certain condominium units*--(A) Escrow accounts need not be established for loans secured by shares in a cooperative; and

(B) Insurance premiums described in paragraph (b)(3)(i) of this section need not be included in escrow accounts for loans secured by condominium units, where the condominium association has an obligation to the condominium unit owners to maintain a master policy insuring condominium units.

(iii) *Cancellation*. A creditor or servicer may permit a consumer to cancel the escrow account required in paragraph (b)(3)(i) of this section only in response to a consumer's dated written request to cancel the escrow account that is received no earlier than 365 days after consummation.

(iv) *Definition of escrow account*. For purposes of this section, ``escrow account'' shall have the same meaning as in 24 CFR 3500.17(b) as amended.

Note: Compliance with paragraph (b)(3) is mandatory effective 4/1/2010 (10/1/2010 for higher-priced mortgage loans secured by manufactured housing). 73 *Federal Register* 44595 and Official Staff Interpretations to § 226.1(d)(5).

(4) *Evasion; open-end credit*. In connection with credit secured by a consumer's principal dwelling that does not meet the definition of open-end credit in Sec. 226.2(a)(20), a creditor shall not structure a home-secured loan as an open-end plan to evade the requirements of this section.

Regulation Z — Truth in Lending

Supplement I to Part 226—Official Staff Interpretations

Section 226.35—Prohibited Acts or Practices in Connection With Higher-priced Mortgage Loans

Added Effective 10/1/2009.

35(a) Higher-priced mortgage loans.

Paragraph 35(a)(2).

1. *Average prime offer rate.* Average prime offer rates are annual percentage rates derived from average interest rates, points, and other loan pricing terms currently offered to consumers by a representative sample of creditors for mortgage transactions that have low-risk pricing characteristics. Other pricing terms include commonly used indices, margins, and initial fixed-rate periods for variable-rate transactions. Relevant pricing characteristics include a consumer's credit history and transaction characteristics such as the loan-to-value ratio, owner-occupant status, and purpose of the transaction. To obtain average prime offer rates, the Board uses a survey of creditors that both meets the criteria of Sec. 226.35(a)(2) and provides pricing terms for at least two types of variable-rate transactions and at least two types of non-variable-rate transactions. An example of such a survey is the Freddie Mac Primary Mortgage Market Survey®.

2. *Comparable transaction.* 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 the specified margin. The table of average prime offer rates published by the Board indicates how to identify the comparable transaction.

3. *Rate set.* A transaction's annual percentage rate is compared to the average prime offer rate as of the date the transaction's interest rate is set (or "locked") before consummation. Sometimes a creditor sets the interest rate initially and then re-sets it at a different level before consummation. The creditor should use the last date the interest rate is set before consummation.

4. *Board table.* The Board publishes on the Internet, in table form, average prime offer rates for a wide variety of transaction types. The Board calculates an annual percentage rate, consistent with Regulation Z (see Sec. 226.22 and appendix J), for each transaction type for which pricing terms are available from a survey. The Board estimates annual percentage rates for other types of transactions for which direct survey data are not available based on the loan pricing terms

available in the survey and other information. The Board publishes on the Internet the methodology it uses to arrive at these estimates.

35(b) Rules for higher-priced mortgage loans.

1. *Effective date.* For guidance on the applicability of the rules in Sec. 226.35(b), see comment 1(d)(5)-1.

Paragraph 35(b)(2)(ii)(C).

1. *Payment change.* Section 226.35(b)(2) provides that a loan subject to this section may not have a penalty described by Sec. 226.32(d)(6) unless certain conditions are met. Section 226.35(b)(2)(ii)(C) lists as a condition that the amount of the periodic payment of principal or interest or both may not change during the four-year period following consummation. For examples showing whether a prepayment penalty is permitted or prohibited in connection with particular payment changes, see comment 32(d)(7)(iv)-1. Those examples, however, include a condition that Sec. 226.35(b)(2) does not include: the condition that, at consummation, the consumer's total monthly debt payments may not exceed 50 percent of the consumer's monthly gross income. For guidance about circumstances in which payment changes are not considered payment changes for purposes of this section, see comment 32(d)(7)(iv)-2.

2. *Negative amortization.* Section 226.32(d)(2) provides that a loan described in Sec. 226.32(a) may not have a payment schedule with regular periodic payments that cause the principal balance to increase. Therefore, the commentary to Sec. 226.32(d)(7)(iv) does not include examples of payment changes in connection with negative amortization. The following examples show whether, under Sec. 226.35(b)(2), prepayment penalties are permitted or prohibited in connection with particular payment changes, when a loan agreement permits negative amortization:

i. Initial payments for a variable-rate transaction consummated on January 1, 2010 are $1,000 per month and the loan agreement permits negative amortization to occur. Under the loan agreement, the first date that a scheduled payment in a different amount may be due is January 1, 2014 and the creditor does not have the right to change scheduled payments prior to that date even if negative amortization occurs. A prepayment penalty is permitted with this mortgage transaction provided that the other Sec. 226.35(b)(2) conditions are met, that is: provided that the prepayment penalty is permitted by other applicable law, the penalty expires on or before December 31, 2011, and the penalty will not apply if the source of the prepayment funds is a refinancing by the creditor or its affiliate.

ii. Initial payments for a variable-rate transaction consummated on January 1, 2010 are $1,000 per month and the loan agreement permits negative amortization to occur. Under the loan agreement, the first date that a scheduled payment in a different amount may be due is January 1, 2014, but the creditor has the right to change scheduled payments prior to that date if negative amortization occurs. A prepayment penalty is prohibited with this mortgage transaction because the payment may change within the four-year period following consummation.

35(b)(3) Escrows.

Paragraph 35(b)(3)(i).

1. Section 226.35(b)(3) applies to principal dwellings, including structures that are classified as personal property under state law. For example, an escrow account must be established on a higher-priced mortgage loan secured by a first-lien on a mobile home, boat or a trailer used as the consumer's principal dwelling. See the commentary under Sec. Sec. 226.2(a)(19), 226.2(a)(24), 226.15 and 226.23. Section 226.35(b)(3) also applies to higher-priced mortgage

loans secured by a first lien on a condominium or a cooperative unit if it is in fact used as principal residence.

2. *Administration of escrow accounts.* Section 226.35(b)(3) requires creditors to establish before the consummation of a loan secured by a first lien on a principal dwelling an escrow account for payment of property taxes and premiums for mortgage-related insurance required by creditor. Section 6 of RESPA, 12 U.S.C. 2605, and Regulation X address how escrow accounts must be administered.

3. *Optional insurance items.* Section 226.35(b)(3) does not require that escrow accounts be established for premiums for mortgage-related insurance that the creditor does not require in connection with the credit transaction, such as an earthquake insurance or debt-protection insurance.

Paragraph 35(b)(3)(ii)(B).

1. *Limited exception.* A creditor is required to escrow for payment of property taxes for all first lien loans secured by condominium units regardless of whether the creditors escrows insurance premiums for condominium unit [sic].

Editor's note: Paragraph 1 above probably should read as follows:

1. *Limited exception.* A creditor is required to escrow for payment of property taxes for all first lien loans secured by condominium units regardless of whether the creditor escrows insurance premiums for a condominium unit.

November 16, 2009
The Federal Reserve Board has clarified its new HOEPA lending standard so that lenders can refinance short-term balloon mortgages on farmhouses and other rural residences. Rural lenders make nonconforming 3-year and 5-year balloon mortgages that they hold in portfolio. They raised concerns that the Home Ownership and Equity Protection Act regulations that went into effect Oct. 1 could prohibit such products. The HOEPA rule requires lenders to evaluate the borrower's ability to repay a loan. On higher-cost balloon mortgages with a term of less than seven years, it appeared the borrower must be able to pay off the mortgage in full at the end of the term. FRB director of consumer affairs Sandra Braunstein said there is "no" such pay off requirement since it would effectively ban short-term balloon loans. "If the Board had intended to ban such products it would have done so explicitly," she says in a letter to banking trade groups and bank examiners. In making the loan, the lender should "verify that the consumer would likely be able to satisfy the balloon payment obligation by refinancing the loan or through income or assets other than the collateral," Mr. Braunstein says

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