



# REGULATORY COMPLIANCE OUTLOOK:

April 2010

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## Escrow Requirements for Higher-Priced Mortgage Loans

In July 2008, the Federal Reserve Board approved a final rule, which amends Regulation Z (the Truth-in-Lending Act) and was adopted under the Homeownership and Equity Protection Act (HOEPA). The new rule addressed and defined "higher-priced mortgage loans" (HPML), a new category of mortgage loans, while also providing additional protection to consumers.<sup>1</sup> Most requirements of the rule were to be implemented on Oct. 1, 2009.

Four key protections were provided to consumers:

- ❖ **Borrower Ability:** Lenders must take a borrower's ability to repay the loan from income and assets other than the home's value into account when making the loan.
- ❖ **Verification of Income/Assets:** Lenders must verify the income and assets they rely upon to determine repayment ability.
- ❖ **Prepayment Penalty:** Prepayment penalties are prohibited if the mortgage payments can change in the first four years; and, for other higher-priced loans, a prepayment penalty period cannot last for more than two years.
- ❖ **Escrow Accounts:** Lenders must establish escrow accounts for property taxes and homeowner's insurance for all first-lien mortgage loans.

### HPML calculation

Determining if a loan is an HPML origination requires a calculation using a specific "survey-based index," as follows:

#### Survey-Based Index

The rule establishes a category of "higher-priced mortgage loans" secured by a consumer's principal dwelling, defined as a first lien mortgage that has an annual percentage rate (APR) that is 1.5 percentage points or more above the "average prime offer rate," or, if the loan is a subordinate lien loan, 3.5 percentage points above this Survey-Based Index.

The average prime offer rate index is based on a survey published by Freddie Mac, and can be found on Freddie Mac's website at the following tab: Weekly Primary Mortgage Market Survey.

The rule's definition of an HPML origination captures virtually all loans in the sub-prime market, but generally excludes loans in the prime market.

### Effective date: April 1, 2010

The escrow account requirement must be implemented on April 1, 2010. This deferral of the requirement until April 1, 2010 was given in order to provide originators sufficient time to set up escrow account procedures. Lenders must become familiar with federal and state escrow account requirements.

### Implementation dates

- ❖ Effective April 1, 2010, the lender will be required to set up an escrow account for residential real estate-secured HPMLs.
- ❖ Effective Oct. 1, 2010, the lender will be required to set up an escrow account for non-real estate-secured (principal dwelling) HPMLs (i.e., manufactured homes).

### Escrow requirements

Effective with the dates indicated above for the respective types of HPMLs, the

lender must set up an escrow account for loans subject to the HPML escrow requirements. Escrow mandates only affect first lien transactions. (Exception: Escrow is not required for a condominium, if the condominium association maintains a master policy that covers the individual condominium units for items such as homeowner's insurance and property taxes.)

The HPML origination's escrow account must be set up to pay items such as property taxes and premiums for mortgage-related insurance (such as homeowner's insurance) that the lender has required.

### RESPA requirements

Escrow requirements under federal law, such as under the Real Estate Settlement Procedures Act (RESPA), must be implemented. RESPA provides detailed escrow requirements, escrow account calculation methodologies, and also some model forms.<sup>2</sup>

#### Some salient RESPA requirements for escrow accounts

- ❖ Disclosure of the initial escrow account statement at the time an escrow account is established.
- ❖ Annual escrow account disclosure.
- ❖ Certain limitations on how the escrow account is funded, ensuring that the account is not "overfunded" with the borrower's money.

### State requirements

State law places further requirements on escrow accounts. Some states exceed RESPA's mandates in limiting the amount of the "escrow cushion." Additionally, state law might require the lender to pay interest on the amount in the escrow account.

### Submit your questions ...

Do you have a regulatory compliance issue that you'd like to see addressed in the Regulatory Compliance Outlook Column? If so, e-mail your issue or concern to Jonathan Foxx at [jfoxx@lenderscompliancegroup.com](mailto:jfoxx@lenderscompliancegroup.com).

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### Footnotes

1—Compliance with the new rules, other than the escrow requirement, is mandatory for all applications received on or after Oct. 1, 2009. The escrow requirement has an effective date of April 1, 2010 for site-built homes, and Oct. 1, 2010 for manufactured homes.

2—See 24 CFR 3500.17, RESPA's Escrow Requirements section, for further information on RESPA escrow requirements. The U.S. Department of Housing & Urban Development (HUD) publishes a number of Public Guidance Documents that illustrate the proper way to fund and manage an escrow account.