



Time is running out!
Are you ready to comply?

Regulation Z Changes Are on Their Way!

Q and A Guidance on Getting Ready

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On July 14, 2008, the Federal Reserve Board (FRB) exercised its broad authority under HOEPA to prohibit abusive mortgage lending practices by revising Regulation Z. The most significant change is the addition of a new category of loans, "higher-priced" mortgage loans that are subject to several restrictions.

Q: When do the amendments to Regulation Z take effect?

The July 30, 2008, published amendment to Regulation Z and specifically the new restrictions under Sections 34 and 35 become effective with applications as of October 1, 2009. There is an exception to this date. The escrow requirements related to "higher-priced" mortgages has a mandatory compliance date of April 1, 2010.

Q: What are the new "higher-priced mortgages?"

Section 35 has added a new category of loans sandwiched between prime loans and HOEPA (Section 32) high cost loans. These new loans are called "higher-priced mortgages". The new higher-priced mortgages encompass more loans than the long standing HOEPA restrictions and may force lenders to change operational processes to comply with the restrictions rather than playing the avoidance game like they have done for so many years under Section 32.

Higher-priced mortgages are 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
- 3.5 or more percentage points for loans secured by a subordinate lien on a dwelling.

This loan category includes Purchase as well as refinance transactions and construction-to-permanent loans.

Q: How is the threshold for higher-priced mortgages determined?

The threshold for a higher-priced mortgage is determined by reference to the average prime offer rate which is a newly published annual percentage rate 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 average prime offer rate ("APOR") will be calculated and published by the Federal Reserve Board every Friday morning on the internet. The new benchmarks will be effective the following Monday. There will be separate benchmarks for fixed rate loans which utilize the loan maturity as the term of the loan and variable rate loans for which the term is the initial fixed rate period (i.e., the period until the first scheduled rate reset). The Annual Percentage Rate on the loan at closing is compared to the corresponding APOR as of the date the rate on the loan was last locked. For example:

- Friday October 2, 2009 rates are posted
- Monday October 5, 2009 – benchmarks are effective

Loans locked in (Monday) October 5 – (Sunday) October 11, 2009 use the October 5th benchmarks.

Q: Are there any additional requirements on the lender that originates a higher-priced mortgage loan?

Yes, when a lender originates a loan meeting the Higher-priced mortgage threshold there are additional requirements which must be fulfilled. First, the lender must consider the borrower's ability to repay the loan based on an analysis of the borrower's verified income and assets other than the value of the property. The analysis must be based on all of the facts known to the lender at the time the loan closes. If you know about a change in the borrower's situation or the fact that they will secure a piggyback second as part of the transaction then you must use the information in your analysis. Income and assets relied upon in the credit decision are required to be verified with reasonable third party written documentation which is specific to the consumer. The verification cannot be verbal or generic to a type of occupation or geographic area. A credit report is still a viable source of verification as long as current obligations which may be listed on the application but not yet reported to the credit bureau are considered in the analysis. Additionally, mortgage related obligations such as expected property taxes, mortgage-related insurance premiums required by the creditor, homeowner's association dues, and condominium fees are required to be included in your analysis of the borrower's ability to repay.

Q: How does a bank gauge compliance?

The lender can afford itself of a presumption of compliance if it (1) verified repayment ability, (2) determines the payment obligation, and (3) measures the relationship of obligations to income. The regulation very specifically requires that the repayment ability be calculated on the highest scheduled payment in the first seven years of the loan, taking into account current obligations and mortgage-related obligations. For example:

- A fixed-rate loan with interest only payments for 5 years. The monthly payment for the first 5 years is \$667 (interest only) and then the monthly payment after the first 5 years goes up to \$772 (fully amortized amount). The \$772 monthly payment is used in the analysis as this is the highest scheduled payment in the first seven years of the loan.
- A balloon loan with a term shorter than 7 years does not qualify for the presumption of compliance as the board deemed them to be riskier loans. Instead compliance with the requirements is determined on all of the facts and circumstances surrounding the underwriting of the loan.

Q: Can banks impose a prepayment penalty on a higher-priced mortgage?

A higher-priced mortgage is also prohibited from imposing a prepayment penalty if the monthly payment on the loan can change in the initial four years following consummation. If the payment does not change in the initial 4 year period, the prepayment penalty is still limited to a maximum period of two years following closing. A prepayment penalty is prohibited entirely if refinancing an existing loan subject to either HOEPA or Higher-priced mortgage restrictions. Failing to follow the prepayment penalty restrictions can extend the consumer's existing right of rescission to three years.

Q: What type of escrow account is required?

When originating a Higher-priced mortgage the creditor is required to establish an escrow account for property taxes and homeowner's insurance on loans secured by a first lien loan on a consumer's principal dwelling. Co-op and condominium units where the condominium association has an obligation to maintain a master policy insuring the units are exempt from this requirement. The consumer can request that the servicer cancel the escrow account as long as the request is in writing and made no earlier than 365 days after consummation.

Q: What can banks do to prepare for the higher-priced mortgage changes?

With all of this said, here are a few steps banks can take now to ensure readiness before accepting applications on October 1, 2009:

- Confirm a systematic process is in place for checking each application against the Section 32 (HOEPA) and higher-priced mortgage thresholds. The check must be done initially at application to ensure that a loan meeting or exceeding the thresholds gets the appropriate level of review.
- Update loan processing procedures to include proper verification of the borrower's ability to repay a higher-priced mortgage.
- Ensure systems or processes capture the last date the rate is locked prior to closing, the initial fixed rate period for each variable rate product, the type of ARM is easily accessible for selecting the comparable transaction from the APOR table, and that the APOR table can be accessed weekly when published.
- Educate staff on the terminology and requirement differences between Section 32 (HOEPA) and higher-priced mortgages.

Solutions and Consulting Services for Regulation Z Compliance from Wolters Kluwer Financial Services | PCi

PCi offers consulting services and technology solutions to prepare for compliance with the changes to Regulation Z. Our consultants are available to update policies and procedures, educate staff and Board members, and recommend technology solutions to bring your bank's compliance efforts in line with the Reg. Z changes. Our APL solution, Wiz Sentinel, in addition to testing loans for HOEPA and state anti-predatory lending compliance, will test loans beginning October 1st against the new "Higher-Priced Mortgage" standard defined under the revised Reg. Z, using the newly published APOR table. For more information call 1-800-261-3111 or visit www.pciwiz.com.