Client Alert.

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Federal Reserve Proposal for Mandatory Escrow Accounts

By Joseph Gabai

BACKGROUND

On August 16, 2010, the Federal Reserve Board ("Board") issued two proposed rules and three final rules governing federal Truth-in-Lending requirements for residential mortgage loans. This Client Alert summarizes the Board's proposal relating to mandatory escrow account requirements for first lien higher-priced mortgage loans ("HPMLs"). If it is issued in final form, this proposal will conform the mandatory escrow account requirements for first lien HPMLs to those imposed by the Wall Street Reform and Consumer Financial Protection Act of 2010 ("Dodd-Frank Act").

Later Client Alerts will address the Board's remaining proposals and final rules.

CURRENT RULE

Section 226.35 of Regulation Z imposes mandatory escrow account and other requirements on all HPMLs. An HPML is a consumer credit transaction secured by the consumer's principal dwelling with an annual percentage rate ("APR") that exceeds the average prime offer rate ("APOR") for a comparable transaction as of the date that the interest rate is set by 1.5% or more for a first lien loan, or 3.5% for a subordinate lien loan. The current rule defines an HPML without regard to the dollar amount of the loan. All HPMLs are subject to a mandatory escrow account rule, with certain exceptions. See Section 226.35(b)(3) of Regulation Z.

PROPOSED RULE

The Board is proposing to amend its mandatory escrow account requirement set forth at Section 226.35(b)(3) of Regulation Z. Under the proposed amendment, a first lien loan that is a "jumbo" loan—that is, a loan with a principal balance at consummation that exceeds the maximum principal obligation in effect as of the date that the interest rate is set for the loan to be eligible for purchase by Freddie Mac—will be subject to the mandatory escrow account rule only if the APR exceeds the APOR for a comparable transaction as of the date that the interest rate is set by 2.5% or more. The current Freddie Mac conforming loan limit is $417,000 for a single-family loan that is not located in any of the various designated high-cost areas. The comment period runs for 30 days following publication of the proposal in the Federal Register.

ANALYSIS

- If put into final form, the Board's proposal will conform the mandatory escrow account rule for first lien HPMLs in Regulation Z to the rule mandated by Section 1461 of the Dodd-Frank Act.
- Because this proposal conforms Regulation Z to the Dodd-Frank Act, this should be a "no-brainer." The Board anticipates issuance of a final rule shortly after considering the public's comments to the proposal.

- The Board has specifically solicited comments regarding the effective date of the final rule. It acknowledges that the loans affected by the proposal may become subject to laws in some states that, in the absence of a mandatory escrow account requirement under federal law, will prohibit mandatory escrow accounts. In those states, creditors may require additional time to make the necessary system changes.
- If the proposal is issued in final form, the Regulation Z requirements for HPMLs *other than* the mandatory escrow account obligation will continue to apply to *all* loans that meet the definition of an HPML (*i.e.*, all first lien loans with APRs of 1.5% or more above the APOR, and all subordinate lien loans with APRs of 3.5% or more above the APOR). These other HPML requirements will continue to apply regardless of the dollar amounts of the loans. For example, the ability to repay requirement and the restrictions on prepayment penalties will apply to all HPMLs, without regard to whether the loans are jumbo loans or non-jumbo loans. A proposed revision to the Federal Reserve Commentary confirms that the proposal relates solely to the mandatory escrow account requirement.
- If any other provision of law requires the establishment of an escrow account for a first lien jumbo HPML, the escrow account will be required even if the loan will avoid a mandatory escrow requirement under the Board's new jumbo loan proposal. See Section 1461 of the Dodd-Frank Act, which will impose a mandatory escrow account requirement in a variety of other circumstances.
- The Board's proposal is limited to Regulation Z. The Board's Regulation C requires financial institutions to report the difference between the APR and the APOR of an originated loan subject to Regulation Z if that difference is 1.5% or more for a first lien loan, or 3.5% or more for a subordinate lien loan, as of the date the interest rate is set. See Section 203.4(a)(12) of Regulation C. At present, there is no proposal to amend this provision of Regulation C.

Contact:

Joseph Gabai
(213) 892-5284
jgabai@mofo.com

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