

Higher-Priced Mortgage Loans: Are You Making Them? Are You Sure?

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The revisions to Regulation Z, effective October 1, 2009, to implement a new category of mortgage loan—the “Higher Priced Mortgage Loan” (HPML)—and its added consumer protections have caused quite a stir in the mortgage lending industry. This new category of loans should not be confused with the existing HOEPA loans, often referred to as “Section 32” loans. HPMLs have lower rate triggers than HOEPA loans and, therefore, are likely to encompass more loans. In addition, purchase money transactions may meet the definition of an HPML; whereas, the HOEPA rules specifically exempt purchase money transactions. But like HOEPA, the final rules for HPMLs do exclude home equity lines of credit, construction loans and reverse mortgages.

Identifying HPMLs

Properly identifying HPMLs will be critical for mortgage lenders. An HPML is defined as “*consumer credit transactions secured by a consumer’s principal dwelling with an annual percentage rate (APR) 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.”*

The index, the Average Prime Offer Rate (APOR), is a new index developed by the Federal Reserve Board (the Board). Initially, the Board will base the rate on the Freddie Mac Primary Mortgage Market Survey which is updated on a weekly basis. While the APOR is based on the Freddie Mac rates, they are not one and the same. The Board has developed a very complicated formula from which it will expand Freddie Mac’s four rates posted weekly to a total of 14 mortgage products (six variable rates and eight non-variable rates). The Board will publish the APORs on a weekly basis on the Federal Financial Institutions Examination Council’s (FFIEC) web site.

In order to determine whether a loan is an HPML, the lender must compare the final APR (the APR on the closing documents) to the APOR as of the date that the interest rate is set the final time before closing (also known as the rate lock date). In the event a lender sets the interest rate initially and then resets it at a different level (for example, a rate is set when the loan is approved by loan committee but rates subsequently go down and the lender lowers the borrower’s rate to match a competitor’s rate), the lender must use the date the final interest rate was set.

Lenders must use the most recently available APOR as of the rate-lock date. As stated earlier, the Board will update the APORs weekly, thus, lenders will need to revise their

trigger calculations on a weekly basis as well. The Board has indicated it will update the APOR tables each Friday to be effective the following Monday.

Testing for HPMLs

Lenders may decide they simply are not going to make HPMLs due to the compliance, legal and reputation risks associated with them. This may be easier said than done. While the Board has not started publishing the APOR tables on the FFIEC web site yet, the FFIEC has updated its rate spread calculator for HMDA purposes. Effective October 1, 2009, Regulation C has also been revised to require HMDA reporters to report rate spreads that trigger HPML coverage rather than rate spreads between a Treasury rate and the loan's APR. The new FFIEC rate spread calculator can be found at <http://www.ffiec.gov/ratespread/newcalc.aspx>. It will calculate rate spreads for both fixed and variable rate products. Directions for using the calculator can be found by clicking on the "Help" link on calculator web page.

The new calculator will give lenders an opportunity to "test" their current mortgage rates to determine if they are making HPMLs. Lenders can simply test recently closed loans by indicating the loan type (fixed rate or adjustable), keying in the loan's APR, the rate lock date, loan term and lien position. The calculator will then provide either the applicable rate spread or indicate "NA" —meaning the rate spread was below the 1.5 and 3.5 percent HPML thresholds and thus, does not meet the definition of an HPML.

For example, if a lender locked in an interest rate on March 16, 2009, for a first-lien, five-year balloon note, the loan would meet the definition of an HPML if the loan's final APR was 6.74% or higher. In a similar test, it was found a five-year ARM that was locked in on the same day, March 16, 2009, would meet the definition of an HPML if the loan's APR exceeded 5.52%.

While the Board's intent in developing the rate tables was to encompass subprime or Alt A loans, it is likely many more loans will meet the definition of an HPML. Those loans most likely to meet the definition of an HPML include:

JUMBO LOANS - Even though Jumbo loans are typically made to strong borrowers with good credit, they typically carry higher interest rates simply due to their size.

FIRST LIEN HOME EQUITY LOANS- Many banks price home equity loans (typically non-purchase money transactions) the same whether the loan is in a first or subordinate lien position. Lenders typically base their pricing distinction on loan purpose, not lien position. The HPML pricing thresholds however, make a distinction between first and subordinate lien positions, not loan purpose. This pricing philosophy difference could pull home equity loans that in are in first lien position into coverage.

SMALL MOTGAGE LOANS- Lenders sometimes charge a higher rate of interest on smaller mortgage loans in order to recover overhead costs and to ensure loan profitability.

LOANS WITH PRIVATE MORTGAGE INSURANCE - On average, the cost of private mortgage insurance adds 50 basis points to the cost of a loan. Due to the current high default rates, mortgage insurance companies have adjusted their pricing structure and increased the cost of mortgage insurance to borrowers. Because mortgage insurance is considered a finance charge and impacts the APR calculation, loans with mortgage insurance carry a higher likelihood of meeting the definition of an HPML.

LOAN PRODUCTS WITH NO UP-FRONT CLOSING COSTS - Many lenders have moved to offering low-cost or no-cost loan products for borrowers who lack funds to close but have solid credit histories and adequate repayment capacity. Again, like small mortgage loans, lenders often charge a higher interest rate on these products to recoup origination costs.

If You Make an HPML

Loans that meet the definition of an HPML will be subject to a repayment ability test, have limited prepayment penalties in certain circumstances and, if in a first lien position, must have established escrow accounts for taxes and insurance.

The Repayment Ability Test

Effective October 1, 2009, if a lender makes an HPML, it must verify and document the borrower's repayment ability. A lender does this by verifying the income or assets it relied on to determine a borrower's repayment ability. A lender may include a borrower's expected income if it can be verified. The commentary to this section of Reg. Z indicates a lender should verify repayment ability based on facts and circumstances known at the time of consummation. For example, if lender has knowledge at consummation of reductions in income due to retirement or job loss, this must be considered.

Acceptable sources of income for verifying repayment ability include salary, wages, bonus pay, tips, commissions, retirement benefits, public assistance, alimony, child support, investment income, part-time or seasonal income, gifts, etc. Acceptable verification documents include W-2, tax returns, payroll receipts, other third party documents, award letters, written VOE, etc. However, a lender may not rely on a borrower's stated income or oral verification of employment. In verifying a borrower's current and expected obligations, the lender can rely on debts listed on a credit report and must also include new mortgage-related debt including principal, interest, expected property taxes, mortgage insurance (if applicable), home owners association dues, etc. Lenders should also include "piggy-back" second-lien transactions used for down payment or closing costs if applicable.

The final rule provides a "Presumption of Compliance" clause. That is, a lender is presumed to have complied with repayment ability test if it:

Verifies consumer's repayment ability;

Determines the consumer's repayment ability using the largest payment of principal and interest scheduled (according to the payment schedule on the final TIL) in the first seven years following consummation and taking into consideration current obligations and mortgage-related obligations (e.g., taxes, insurance, etc.);

Assesses repayment ability based on total debt-to-income ratio or the consumer's residual income after paying all debts. (It is important to note maximum debt-to-income ratios or minimum residual income limits are not provided in the regulation.)

Creditors are NOT required to meet presumption of compliance test but doing so provides the bank some protection from both a compliance standpoint and legal risk.

Prepayment Penalty Provisions

Loans that meet the definition of an HPML, can only assess a prepayment penalty if:

It is otherwise permitted by law; (Note: Iowa Code prohibits state-chartered banks from imposing a prepayment penalty on any residential real estate loan.)

The penalty can only be assessed during the first two (2) years following consummation of the loan;

The source of the prepayment funds is not a refinancing by the creditor or affiliate; and

The amount of the periodic payment of principal or interest or both does not change during the first four-year period following consummation.

Escrow Provisions

A lender must establish escrow accounts for all first-lien HPMLs it makes. The final rule provides a delayed mandatory compliance date for the escrow provisions:

Effective for applications for site built homes as of April 1, 2010.

Effective for applications for manufactured homes on October 1, 2010.

The escrow accounts must be established at or before consummation and must escrow for property taxes and premiums for mortgage-related insurance required by creditor (E.g., insurances against loss or damage to property; insurance protecting creditor against the consumer's default or other credit loss, etc.) Lenders are not required to escrow for optional insurance purchased by borrower such as earthquake insurance or debt-protection. The establishment and ongoing maintenance of the escrow accounts must comply with RESPA's escrow rules.

There are two exemptions from the escrow requirement provided in the final rule: (1) loans secured by shares in a cooperative; and (2) loans secured by individual condominium units, where the condominium association has an obligation to the condominium unit owners to maintain a master policy insuring condominium units.

However, in the case of condominiums, lenders must still must escrow for taxes even when the association maintains the insurance.

Oddly enough, the final rule does permit a lender or servicer to allow a borrower to cancel the escrow account one year after consummation. The borrower cannot opt out initially of the escrow requirement. The lender does not, however, have to offer this option!

Borrowers wishing to opt out of the escrow requirement after the first year of repayment must provide a dated, written request to cancel the escrow account. All obligated borrowers must sign the request.

Compliance Action Steps

Six months may seem like plenty of time to prepare for the upcoming changes to Reg. Z, but the changes are substantial and will require significant planning. While a lender's action plan may vary depending on its size, operating systems and product offerings, it should include the following basic elements:

- Conduct a risk assessment to identify all the areas of operations that will be affected. Specifically, consider which products or business lines will be subject to the HPML rules.

- Determine which regulatory requirements apply to these products and assess whether the institution currently complies with any of the new requirements. Put in place procedures to properly identify HPMLs or prevent the origination of them if the lender opts for this approach to compliance.

- Develop procedures and processes to determine a borrower's repayment ability. Implement escrow systems in compliance with RESPA.

- Conduct staff training. This will be critical for successful compliance with the new HPML requirements. Training is most effective when tailored to an individual's job responsibilities and should include not only a review of the new regulatory requirements but also the lender's policies and procedures for compliance.

- Modify internal controls to ensure compliance.

- Expand compliance audits initially after the lender's compliance plan has been implemented to ensure the plan is being followed.

Editor's Note: This article only discusses the Reg. Z revisions related to HPMLs that are effective October 1, 2009. In addition to these provisions, the October 1, 2009 Reg. Z revisions expand the requirement to provide an early Truth in Lending disclosure, dramatically change the advertising rules and provide other added protections for all loans secured by a borrower's dwelling. Those provisions will be discussed in future Disclosure articles.

