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Updated: September 29, 2009 (Revisions are highlighted in yellow)

In a letter to HUD Secretary Shaun Donovan dated September 29, 2009, the Federal Reserve Board has reversed its position with respect to the prepayments on FHA loans. Prior to the date of this letter, the staff of the Division of Consumer and Community Affairs of the Federal Reserve Board (the group responsible for issuing official interpretations of Regulation Z) took the position that interest charged on an FHA loan for prepayments made other than on a regularly scheduled payment due date from the date of prepayment until the next installment due date should be treated as a prepayment penalty for disclosure purposes. In this letter, however, the staff takes the position (consistent with HUD's interpretation) that "(l)enders that engage in this [monthly interest accrual amortization] practice would not be required to treat the interest charged from the date of prepayment until the next installment due date as a prepayment penalty **for any purpose under Regulation Z**." The letter includes a statement that the letter may be relied upon as an official interpretation of Regulation Z that, under TILA, relieves creditors of liability for actions taken in good faith reliance upon the guidance set forth in the letter to the same extent as if set forth in the commentary to Regulation Z. Because of this definitional change, it is permissible for FHA loans to also be HPML loans. The audit described under the heading "HPML Regulations and FHA Loans" below has been removed. For more information on FHA prepayment disclosures, click here.

Previously, we wrote about certain amendments to Regulation Z (12 CFR part 226), specifically as they related to the creation of a new category of loans called "higher-priced mortgage loans." The provisions relating to higher-priced mortgage loans (which we will refer to in this article as "HPML" or "Section 35" loans) are set forth, not surprisingly, in new Regulation Z Section 226.35 (available here). New Regulation Z Section 226.35 applies to loans for which a creditor receives an application on or after October 1, 2009. Below is a description of the new audit DocMagic will be implementing to assist you in identifying HPML loans.

Coverage

The HPML regulations define a higher-priced mortgage loan as a "consumer credit transaction secured by the consumer's principal dwelling" where the annual percentage rate (APR) exceeds certain thresholds as described below. Regulation Z Section 226.2(a)(12) defines "consumer credit" as "credit offered or extended to a consumer primarily for personal, family, or household purposes." Accordingly, loans secured by commercial, industrial, multifamily, second homes, and non-owner-occupied (investment) properties fall outside the scope of Regulation Z Section 226.35. The term "principal dwelling" means owner-occupied real property.[1] Regulation Z Section 226.35 covers both purchase money and refinance loans, regardless of lien position, and appears to include government loans such FHA, VA and USDA loans. Construction loans, "bridge loans" (loans with terms of 12 months or less), reverse mortgages and HELOCs are also specifically excluded from coverage of Regulation Z Section 226.35.

Higher-Priced Mortgage Loan Defined

A "higher-priced mortgage loan" is defined as a consumer credit transaction secured by the consumer's principal dwelling for which the loan APR exceeds the average prime offer rate for a comparable transaction as of the date the interest rate is set by either:

(i) 1.5% or more (for a loan secured by a first lien); or
(ii) 3.5% or more (for a loan secured by a subordinate lien).

The "average prime offer rate" is defined by reference to the average prime offer rates published by the Board of Governors of the Federal Reserve. The average prime offer rates are a survey-based estimate of APRs currently offered on prime mortgage loans of a comparable type. The Board publishes two separate tables, one for fixed rate loans (the "Average Prime Offer Rates - Fixed" accessible here) and another for adjustable rate loans (the "Average Prime Offer Rates - Adjustable" accessible here). Average prime offer rates are published on a weekly basis on Friday, effective as of the following Monday. Additional information about the average prime offer rates is available here and here.

Higher-Priced Mortgage Loan Determination and Audit

The process by which a higher-priced mortgage loan determination is made, and the important factors to consider in that process, are as follows:

Determine the Loan APR: The calculated loan APR is used.

Determine the average prime offer rate for a comparable transaction: As mentioned above, the average prime offer rates published on the FFIEC website are divided into two tables: one for fixed rate loans, the other for adjustable rate loans. Within each table, an average prime offer rate is published for loan terms ranging from one year to 50 years. Loan terms are expressed in full years and are generally rounded up for fractional years of .5 or greater, and rounded down for fractional years less than .5. Loans that are payable on demand have an assumed term of 1 year. The commentary to 12 CFR 226.35 (available here) provides that "the table of average prime offer rates published by the FFIEC indicates how to identify the comparable transaction." From the information on the FFIEC website, a comparable transaction means a loan with a comparable loan term, determined as follows:

(a) For a **fixed-rate loan**, the term is the **loan's maturity** (i.e. the period until the last payment will be due under the loan contract) and not its amortization period. For example, for a fixed rate, balloon loan with a 30 year amortization period due in 15 years, the loan term is 15 years.

(b) For a **variable-rate loan**, the term is the **initial, fixed-rate period** (i.e. the period until the first scheduled rate adjustment) and not the loan's maturity. For example, for an adjustable rate loan with a 30 year term to maturity and with an initial fixed-rate period of 3 years, the loan term is 3 years. Similarly, if the initial fixed-rate period is six (6) months, the loan term is one (1) year.

Determine lien position and add the applicable rate spread: for first lien loans, 1.5% is added to the comparable average prime offer rate; for subordinate lien loans, 3.5% is added to the comparable average prime offer rate.

Compare the APR to the comparable average prime offer rate plus the applicable rate spread: if the loan APR is greater than the comparable average prime offer rate plus the applicable rate spread, then the loan is an HPML and the DocMagic system will return a warning when the worksheet is audited or processed substantially as follows:

WARNING: THIS IS A FEDERAL HIGHER-PRICED MORTGAGE LOAN (REG. Z SECTION 226.35)

The average prime offer rate **as of the date the interest rate is set** for the comparable type of loan (fixed or ARM) and loan term is used. In order to determine which average prime offer rate to use, a "Rate Lock Date" must be entered in the worksheet. If the Rate Lock Date has not yet been established, we suggest that you simply enter the date on which you are running the audit until such time as the Rate Lock Date is established. If the Rate Lock Date is missing, the DocMagic system will default to the document date.

HPML Display

Given the importance of this new category of higher-priced mortgage loans, in addition to the warning discussed above, we have opted to include an additional display of the calculation methodology used to arrive at our HPML determination. The display will look similar to the following in a tab located next to the current Section 32 tab in DocMagic:

Higher-Priced Mortgage Loan (HPML) Test

Rate Lock Date:	10/03/2009	Avg. Prime Offer Rate Used:	5.10%
Avg. Prime Offer Rate Pub. Date:	09/28/2009	Avg. Prime Offer Rate Used + Rate Spread:	6.60%
Amortization Type:	Fixed Rate	Loan APR:	7.47%
Loan Term (years):	30 years	Percentage Over/Under:	-0.87%
Lien Status:	First Lien	Is this a Higher-Priced Mortgage Loan?	Yes

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Special Provisions Applicable to Higher-Priced Mortgage Loans

Higher-priced mortgage loans will be subject to a number of restrictions and prohibitions, including but not limited to the following:

creditors shall not extend credit based on the value of the security property without regard to the borrower's repayment ability, including the borrower's current and reasonably expected income, employment, assets other than the security property, and mortgage-related obligations, such as property taxes, mortgage insurance, and similar expenses;

other than with respect to bridge loans of 12 months or less, creditors must verify the borrower's repayment ability by verifying the income or assets by using IRS W-2s, tax returns, payroll receipts, or third-party documentation that provide reasonably reliable evidence of the borrower's income or assets, as well as the borrower's current obligations;

there is a presumption of compliance if the creditor verifies the borrower's repayment ability as provided in the regulation, and uses the largest payment of principal and interest scheduled in the first seven (7) years of the loan (taking into account the borrower's current obligations and mortgage-related obligations), and takes into account either the borrower's total debt to income ratio, or the borrower's income after paying debt obligations;

however, the presumption does not apply to loans that provide for negative amortization or a balloon payment during the first seven (7) years of the loan.

prepayment penalties are allowed provided they are otherwise permitted by law, are limited to two years, the penalty will not apply if the source of prepayment funds is a refinancing by the creditor or creditor affiliate, and the periodic payment of principal or interest or both is fixed for at least the first four years following consummation; and

creditors must establish an escrow account before consummation for the payment of property taxes, homeowners' insurance, and mortgage insurance, if the loan is secured by a first lien on a borrower's principal dwelling; creditors may offer a borrower the opportunity to cancel the escrow after the first 12 months following consummation (this final provision does not become effective until April 1, 2010 (and not until October 1, 2010 if the loan is secured by manufactured housing)).

HPML Prepayment Audit and Documents

Fannie Mae has announced that they will purchase HPML loans provided that, among other things, the HPML meets the Regulation Z requirements with respect to HPMLs. See here. To better assist our users in ensuring compliance with Regulation Z's HPML requirements, we have created the following additional complementary HPML prepayment audit.

As mentioned above, prepayment penalties on HPMLs are allowed provided that under the terms of the loan, they are, among other things: (i) limited to two years, (ii) the penalty will not apply if the source of prepayment funds is a refinancing by the creditor or creditor affiliate, and (iii) the periodic payment of principal or interest or both is fixed for at least the first four years following consummation. Accordingly, if we determine that a loan is an HPML, and the loan provides for a prepayment penalty, then:

(a) if the prepayment penalty period exceeds 24 months, the DocMagic system will return a warning, when the worksheet is audited or processed, substantially as follows:

WARNING: THIS IS A FEDERAL HIGHER-PRICED MORTGAGE LOAN (REG. Z SECTION 226.35); THE TERM OF THE PREPAYMENT PENALTY MAY NOT EXCEED 24 MONTHS; or

(b) if the regularly scheduled periodic payment of principal or interest, or both, varies during the first 48 months of the loan, the DocMagic system will return a warning, when the worksheet is audited or processed, substantially as follows:

WARNING: THIS IS A FEDERAL HIGHER-PRICED MORTGAGE LOAN (REG. Z SECTION 226.35); THE REGULARLY SCHEDULED PERIODIC PAYMENT OF PRINCIPAL OR INTEREST, OR BOTH, MAY NOT VARY DURING THE FIRST 48 MONTHS OF THE LOAN

If both (a) and (b) are applicable, then both warnings will be returned.

In addition to the foregoing audits, Regulation Z Section 226.35(b)(2)(ii) also requires that "[u]nder the terms of the loan...[t]he penalty will not apply if the source of the prepayment funds is a refinancing by the creditor or an affiliate of the creditor...." The phrase "under the terms of the loan" seems to mean, or at a minimum, strongly suggests, that the loan documents, to the extent they permit a prepayment penalty, must include specific language requiring that the penalty will not apply in the circumstance outlined above. Accordingly, in addition to the audits outlined above, if we determine that a loan is an HPML, and the loan provides for a prepayment penalty, we will default in the closing loan package a Higher-Priced Mortgage Loan Addendum to Prepayment Penalty Addendum/Rider ("Addendum") that amends the prepayment rider to the security instrument and the prepayment addendum to the note to modify the terms of the prepayment penalty by including a statement substantially as follows: **The prepayment penalty will not apply if the source of the prepayment funds is a refinancing by the creditor or an affiliate of the creditor.**

Additionally, the Addendum will include the other two prepayment penalty restrictions under the HPML, namely, that under the terms of the loan, the prepayment penalty is limited to two years and, in order for the prepayment penalty to be charged, the periodic payment of principal or interest or both must be fixed for at least the first four years following consummation of the loan.

~~**HPML Regulations and FHA Loans**~~

~~In March 2009, we wrote about the FHA-specific TIL disclosure statement we had created to include special prepayment language. Briefly, FHA loans permit prepayment without penalty on the first day of any month. However, if a prepayment is made on a day other than the first of the month, the borrower is charged interest on the loan through the end of the month in which prepayment is made. For purposes of disclosure under Regulation Z, this additional interest charged through the end of the month in which prepayment is made is deemed to be, and must be disclosed as, a prepayment penalty. The important thing to note is that there is **no time limit** on the prepayment period on FHA loans, meaning that **an FHA loan can never meet the requirements applicable to prepayment penalties on HPMLs**. The bottom line is that FHA loans cannot exceed applicable HPML thresholds; the terms of FHA loans that exceed applicable HPML thresholds must be revised to reduce the loan's APR to below the HPML threshold. Accordingly, if an FHA loan is found to exceed the applicable HPML threshold, the DocMagic system will return a **fatal warning,** when the worksheet is audited or processed, substantially as follows:~~

~~**WARNING: THIS FHA LOAN IS A FEDERAL HIGHER-PRICED MORTGAGE LOAN (REZ. SECTION 226.35) AND DOES NOT MEET REQUIRED PREPAYMENT PENALTY LIMITATIONS; YOU MUST REDUCE THE APR BELOW THE HPML THRESHOLD**~~

Please feel free to contact DocMagic's Compliance Department if you have any questions or comments regarding this audit.

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1 "Principal dwelling" is not expressly defined in Regulation Z itself. However, there is useful commentary to Regulation Z Sections 226.2(a)(24) (with respect to the definition of a "residential mortgage transaction") and 226.23(a)(1) (with respect to rescission) as to the meaning of "principal dwelling."

Source URL: http://www.docmagic.com/compliance/wizard/2009/september-2009/hpml-audit

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