

FEDERAL RESERVE SYSTEM**12 CFR Part 226**

[Docket No. R-1392]

RIN No. AD 7100-AD54

Regulation Z; Truth in Lending**AGENCY:** Board of Governors of the Federal Reserve System.**ACTION:** Proposed rule; request for public comment.

SUMMARY: The Board is publishing for comment a proposed rule to amend Regulation Z, which implements the Truth in Lending Act (TILA). The proposed rule would implement Section 1461 of the recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act. Section 1461 amends TILA to provide a separate, higher threshold for determining coverage of the Board's escrow requirement applicable to higher-priced mortgage loans, for loans that exceed the maximum principal balance eligible for sale to Freddie Mac.

DATES: Comments on this proposed rule must be received on or before October 25, 2010.

ADDRESSES: You may submit comments, identified by Docket No. R-1392 and RIN No. AD 7100-AD54, by any of the following methods:

- *Agency Web site:* <http://www.federalreserve.gov>. Follow the instructions for submitting comments at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm>.
- *Federal eRulemaking Portal:* <http://www.regulations.gov>. Follow the instructions for submitting comments.
- *E-mail:* regs.comments@federalreserve.gov. Include the docket number in the subject line of the message.
- *Fax:* (202) 452-3819 or (202) 452-3102.

• *Mail:* Address to Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551.

All public comments will be made available on the Board's Web site at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm> as submitted, unless modified for technical reasons. Accordingly, comments will not be edited to remove any identifying or contact information. Public comments may also be viewed electronically or in paper in Room MP-500 of the Board's Martin Building (20th and C Streets, NW.) between 9 a.m. and 5 p.m. on weekdays.

FOR FURTHER INFORMATION CONTACT: Paul Mondor, Senior Attorney, or Kathleen C. Ryan, Senior Counsel, Division of Consumer and Community Affairs, Board of Governors of the Federal Reserve System, Washington, DC 20551, at (202) 452-2412 or (202) 452-3667. For users of Telecommunications Device for the Deaf (TDD) only, contact (202) 263-4869.

SUPPLEMENTARY INFORMATION:**I. Background***A. TILA and Regulation Z*

Congress enacted the Truth in Lending Act (TILA) based on findings that economic stability would be enhanced and competition among consumer credit providers would be strengthened by the informed use of credit resulting from consumers' awareness of the cost of credit. One of the purposes of TILA is to provide meaningful disclosure of credit terms to enable consumers to compare credit terms available in the marketplace more readily and avoid the uninformed use of credit.

TILA's disclosures differ depending on whether credit is an open-end (revolving) plan or a closed-end (installment) loan. TILA also contains procedural and substantive protections for consumers. TILA is implemented by the Board's Regulation Z. An Official Staff Commentary interprets the requirements of Regulation Z. By statute, creditors that follow in good faith Board or official staff interpretations are insulated from civil liability, criminal penalties, and administrative sanction.

In 1994, Congress amended TILA by enacting the Home Ownership and Equity Protection Act (HOEPA). The HOEPA amendments created special substantive protections for consumers obtaining mortgage loans with annual percentage rates (APRs) or total points and fees exceeding prescribed thresholds. The Board adopted final rules implementing the HOEPA amendments to TILA in 1995. 60 FR 15463, Mar. 24, 1995. In addition, TILA Section 129(l)(2)(A), as added by HOEPA, directed the Board to adopt regulations prohibiting acts and practices the Board finds to be unfair and deceptive in connection with mortgage loans. 15 U.S.C. 1639(l)(2)(A).

B. 2008 HOEPA Final Rule

In July of 2008, the Board adopted final rules under the Board's authority pursuant to TILA Section 129(l)(2)(A) to prohibit unfair and deceptive acts and practices in connection with mortgage loans. 73 FR 44522, July 30, 2008 (2008

HOEPA Final Rule). The 2008 HOEPA Final Rule defined a class of "higher-priced mortgage loans" and prohibited certain unfair or deceptive lending and servicing practices in connection with such transactions. The Board also approved revisions to advertising rules for both closed-end and open-end home-secured loans to ensure that advertisements contain accurate and balanced information and do not contain misleading or deceptive representations. Finally, the 2008 HOEPA Final Rule required creditors to provide consumers with transaction-specific disclosures early enough to use while shopping for a mortgage.

Under the 2008 HOEPA Final Rule, a higher-priced mortgage loan is a consumer credit transaction secured by the consumer's principal dwelling with an 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 by 3.5 or more percentage points for loans secured by a subordinate lien on a dwelling. See § 226.35(a)(1). For such loans, the Board prohibited creditors from extending credit based on the value of the consumer's collateral without regard to the consumer's ability to repay the obligation. See § 226.35(b)(1). The Board also placed restrictions on the inclusion of prepayment penalty provisions in higher-priced mortgage loans. See § 226.35(b)(2). Finally, the Board prohibited extending a higher-priced mortgage loan secured by a first lien unless an escrow account is established before consummation for payment of property taxes and premiums for mortgage-related insurance required by the creditor. See § 226.35(b)(3).

C. The Reform Act

On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Reform Act) was signed into law.¹ Section 1461 of the Reform Act creates TILA Section 129D.² TILA Section 129D substantially codifies the requirement that escrow accounts for taxes and insurance be established for first-lien higher-priced mortgage loans, adopted by the Board as part of the 2008 HOEPA Final Rule. As discussed above, the 2008 HOEPA Final Rule imposed the escrow requirement on first-lien transactions having an APR that exceeds the average prime offer rate for a comparable transaction by 1.5 or more percentage points. The Reform Act

¹ Public Law 111-203, 124 Stat. 1376.

² Public Law 111-203, § 1461, 124 Stat. 1376, 2178-81 (to be codified at 15 U.S.C. 1639D).

incorporates this coverage test in new TILA Section 129D, but only for loans that do not exceed the current, maximum original principal obligation for mortgages eligible for purchase by Freddie Mac. TILA Section 129D(b)(3)(A) (to be codified at 15 U.S.C. 1639D(b)(3)(A)).

For loans that exceed the Freddie Mac maximum principal balance, TILA Section 129D provides that the escrow requirement applies only if the APR exceeds the applicable average prime offer rate by 2.5 or more percentage points. TILA Section 129D(b)(3)(B) (to be codified at 15 U.S.C. 1639D(b)(3)(B)). The current maximum principal balance for a mortgage loan to be eligible for purchase by Freddie Mac (or Fannie Mae, which uses the same loan-size limit), assuming a single-family property that is not located in any of various designated "high-cost" areas, is \$417,000.³ Thus, for example, under TILA Section 129D(b)(3), if a single-family mortgage loan's original principal balance is \$415,000, the determination of whether it is subject to the escrow requirement in § 226.35(b)(3) is made using a threshold of 1.5 percentage points over the average prime offer rate; if the principal balance is \$420,000, on the other hand, the determination is made using a threshold of 2.5 percentage points over the average prime offer rate. Loans that are not eligible for purchase by Freddie Mac or Fannie Mae because their loan sizes are too great are widely referred to in the mortgage market as "jumbo" mortgages. Hence, the term "jumbo" is used in this proposed rule to refer to such loans.

II. Summary of the Proposed Rule

In the 2008 HOEPA Final Rule, the Board defined a class of higher-priced mortgage loans and applied special consumer protections to those loans. One of these protections is a requirement to establish an escrow account for first-lien higher-priced mortgage loans. Higher-priced mortgage loans are loans for which the APR exceeds the "average prime offer rate" for a comparable transaction as of the date the loan's interest rate is set, by 1.50 percentage points for first-lien loans and 3.50 percentage points for subordinate-lien loans.

This proposed rule would implement TILA Section 129D(b)(3)(B), as enacted by Section 1461 of the Reform Act, discussed above. Section 129D(b)(3)(B) provides a different, higher threshold for the escrow requirement for first-lien, "jumbo" loans. For such loans, under

this proposal, escrows would be mandatory if the loan's APR exceeds the average prime offer rate for a comparable transaction as of the date the loan's interest rate is set by 2.5 or more percentage points. The Reform Act makes several other changes to TILA, including the escrow requirement, that would not be implemented by this proposed rule. The Board expects to propose rules to implement the other TILA provisions in the Reform Act at a later date.

III. Section-by-Section Analysis

Section 226.35 Prohibited Acts or Practices in Connection With Higher-Priced Mortgage Loans

35(a) Higher-Priced Mortgage Loans 35(a)(1)

As discussed below, the Board is proposing to revise § 226.35(b)(3) to provide a higher threshold for determining whether escrow accounts must be established for certain closed-end mortgage loans secured by a first lien on a consumer's principal dwelling, pursuant to the Reform Act. Under the proposed provision, the threshold for coverage of the escrow requirement for such loans would be 2.5 percentage points, rather than the 1.5 percentage points stated in § 226.35(a)(1), in excess of the average prime offer rate. The Board is proposing a conforming amendment to § 226.35(a)(1) to reflect this exception to the general coverage test for higher-priced mortgage loans.

35(b) Rules for Higher-Priced Mortgage Loans

35(b)(3) Escrows

35(b)(3)(v) "Jumbo" Loans

The Board is proposing a new § 226.35(b)(3)(v) to implement TILA Section 129D(b)(3)(B), as enacted by Section 1461 of the Reform Act, discussed above. Proposed § 226.35(b)(3)(v) provides a higher threshold for determining whether escrow accounts must be established for certain closed-end mortgage loans secured by a first lien on a consumer's principal dwelling. Currently, under § 226.35(a)(1), a first-lien loan is considered a higher-priced mortgage loan and is subject to the escrow requirement if its APR exceeds the average prime offer rate by 1.5 or more percentage points. Pursuant to TILA Section 129D(b)(3)(B), for a closed-end, first-lien loan whose original principal amount exceeds the current maximum loan balance for loans eligible for sale to Freddie Mac as of the date the transaction's rate is set, the applicable

threshold is 2.5, rather than 1.5, percentage points.

Accordingly, proposed § 226.35(b)(3)(v) would provide that for such "jumbo" loans the applicable threshold under § 226.35(a)(1) is 2.5 or more percentage points greater than the average prime offer rate. Proposed staff comment 35(b)(3)(v)-1 would clarify that this higher threshold applies solely to whether a "jumbo" loan is subject to the escrow requirement. The determination of whether "jumbo" loans are subject to the other protections in § 226.35, such as the ability to repay requirements under § 226.35(b)(1) and the restrictions on prepayment penalties under § 226.35(b)(2), would continue to be based on the 1.5 percentage point threshold.

The Board is proposing this amendment to § 226.35(b)(3) pursuant to its authority under TILA Section 105(a) to prescribe regulations to carry out the purposes of TILA. 15 U.S.C. 1604(a). Section 105(a) authorizes the Board to implement TILA's statutory provisions through regulations. New TILA Section 129D is such a statutory provision.

IV. Effective Date of Final Rule

The Board is proposing this change in the escrow requirement's coverage threshold to implement the statutory amendment made by the Reform Act, as discussed above. The amendment relieves mortgage creditors of compliance with the escrow requirement for certain "jumbo" loans. Allowing creditors to use the new coverage threshold immediately upon publication of the final rule would expedite the regulatory relief that Congress intended. On the other hand, creditors will require some time to adapt their systems and procedures to take advantage of the higher threshold. The Board is aware that, when relief is granted from Regulation Z's escrow requirement, in some states the affected loans may become subject to state laws that prohibit mandatory escrow accounts, and creditors may need time to make the system changes necessary to comply with state or local law. The Board therefore solicits comment on the appropriate implementation period for a final rule adopting this proposal. The Board expects to issue a final rule within a short time after considering the public comments. Thus, the Board seeks comment on whether a final rule that is effective immediately upon publication would afford creditors sufficient time to implement the change in their systems and procedures. If not, what amount of additional time would be appropriate?

³ See <http://www.freddiemac.com/sell/selbuln/limit.htm>.

V. Paperwork Reduction Act

In accordance with the Paperwork Reduction Act (PRA) of 1995 (44 U.S.C. 3506; 5 CFR part 1320 Appendix A.1), the Board reviewed the proposed rule under the authority delegated to the Board by the Office of Management and Budget (OMB). The rule contains no collections of information under the PRA. *See* 44 U.S.C. 3502(3). Accordingly, there is no paperwork burden associated with the rule.

VI. Initial Regulatory Flexibility Analysis

In accordance with section 3(a) of the Regulatory Flexibility Act (RFA), 5 U.S.C. 603(a), the Board is publishing an initial regulatory flexibility analysis for the proposed amendments to Regulation Z. The RFA requires an agency either to provide an initial regulatory flexibility analysis with a proposed rule or to certify that the proposed rule will not have a significant economic impact on a substantial number of small entities. Under regulations issued by the Small Business Administration, an entity is considered "small" if it has \$175 million or less in assets for banks and other depository institutions; and \$7 million or less in revenues for non-bank mortgage lenders.⁴

Based on its analysis and for the reasons stated below, the Board believes that this proposed rule would not have a significant economic impact on a substantial number of small entities. Nevertheless, the Board is publishing an initial regulatory flexibility analysis and requesting public comment in the following areas. A final regulatory flexibility analysis will be conducted after consideration of comments received during the public comment period if the Board determines that the rule will have a significant economic impact on a substantial number of small entities.

A. Reasons for the Proposed Rule

Congress enacted TILA based on findings that economic stability would be enhanced and competition among consumer credit providers would be strengthened by the informed use of credit resulting from consumers' awareness of the cost of credit. Congress enacted HOEPA in 1994 as an amendment to TILA. TILA is implemented by the Board's Regulation Z. HOEPA imposed additional substantive protections on certain high-cost mortgage transactions. HOEPA also charged the Board with prohibiting acts or practices in connection with mortgage loans that are unfair,

deceptive, or designed to evade the purposes of HOEPA, and acts or practices in connection with refinancing of mortgage loans that are associated with abusive lending or are otherwise not in the interest of borrowers. As noted above, the Board adopted the 2008 HOEPA Final Rule pursuant to this mandate.

The Reform Act amended TILA to include the higher threshold for coverage of the escrow requirement, as discussed above. This proposed rule would implement that change by amending Regulation Z. These amendments are proposed in furtherance of the Board's responsibility to prescribe regulations to carry out the purposes of TILA.

B. Statement of Objectives and Legal Basis

The **SUPPLEMENTARY INFORMATION** contains this information. In summary, the proposed amendments to Regulation Z are designed to implement the amendment to the coverage test for the escrow requirement enacted by Congress as part of the Reform Act. The legal basis for the proposed rule is in Section 105(a) of TILA. 15 U.S.C. 1604(a).

C. Description and Estimate of Small Entities to Which the Proposed Rule Would Apply

The proposed rule would apply to all institutions and entities that engage in closed-end lending secured by a consumer's principal dwelling. TILA and Regulation Z have broad applicability to individuals and businesses that originate even small numbers of home-secured loans. *See* § 226.1(c)(1). Using data from Reports of Condition and Income (Call Reports) of depository institutions and certain subsidiaries of banks and bank holding companies and data reported under the Home Mortgage Disclosure Act (HMDA), the Board can estimate the approximate number of small entities that would be subject to the rules. For the majority of HMDA respondents that are not depository institutions, however, exact revenue information is not available.

Based on the best information available, the Board makes the following estimate of small entities that would be affected by this proposed rule: According to March 2010 Call Report data, approximately 8,848 small depository institutions would be subject to the rule. Approximately 15,899 depository institutions in the United States filed Call Report data, approximately 11,218 of which had total domestic assets of \$175 million or less and thus were considered small entities

for purposes of the RFA. Of the 3,898 banks, 523 thrifts, 6,727 credit unions, and 70 branches of foreign banks that filed Call Report data and were considered small entities, 3,776 banks, 496 thrifts, 4,573 credit unions, and 3 branches of foreign banks, totaling 8,848 institutions, extended mortgage credit. For purposes of this Call Report analysis, thrifts include savings banks, savings and loan entities, co-operative banks and industrial banks. Further, 1,507 non-depository institutions (independent mortgage companies, subsidiaries of a depository institution, or affiliates of a bank holding company) filed HMDA reports in 2009 for 2008 lending activities. Based on the small volume of lending activity reported by these institutions, most are likely to be small entities.

D. Projected Reporting, Recordkeeping, and Other Compliance Requirements

The changes to compliance requirements that the proposed rule would make are described in part III of the **SUPPLEMENTARY INFORMATION**. The effect of the proposed revisions to Regulation Z on small entities is minimal because the revisions would bring about burden relief; certain mortgage loans that otherwise would be subject to the escrow account requirement in § 226.35(b)(3) would be relieved of that requirement. Some small entities would be required to modify their home-secured credit origination processes once, to implement the revised coverage test. The precise costs to small entities of updating their systems are difficult to predict. These costs will depend on a number of unknown factors, including, among other things, the specifications of the current systems used by such entities to originate mortgage loans and test them for "higher-priced mortgage loan" coverage. The Board seeks information and comment on any costs, compliance requirements, or changes in operating procedures arising from the application of the proposed rule to small businesses.

E. Identification of Duplicative, Overlapping, or Conflicting Federal Rules

The Board has not identified any federal rules that duplicate, overlap with, or conflict with the proposed revisions to Regulation Z. The Board seeks comment on the existence of any such federal laws or regulations.

F. Discussion of Significant Alternatives

The Board believes that no alternatives to the proposed rule are available for consideration. As

⁴ 13 CFR 121.201.

discussed above, the effect of the proposed rule consists primarily of burden relief, thus alternatives that might minimize the impact on small entities are unlikely to exist. Moreover, the proposed rule would implement a specific, numerical adjustment that is mandated by the statute, which limits the Board's flexibility with respect to alternatives. The Board nevertheless welcomes comments on any significant alternatives, consistent with the requirements of TILA, that would minimize the impact of the proposed rule on small entities.

List of Subjects in 12 CFR Part 226

Advertising, Consumer protection, Federal Reserve System, Mortgages, Reporting and recordkeeping requirements, Truth in lending.

Authority and Issuance

For the reasons set forth in the preamble, the Board proposes to amend Regulation Z, 12 CFR part 226, as follows:

PART 226—TRUTH IN LENDING (REGULATION Z)

1. The authority citation for part 226 continues to read as follows:

Authority: 12 U.S.C. 3806; 15 U.S.C. 1604, 1637(c)(5), and 1639(l); Pub. L. 111-24 § 2, 123 Stat. 1734.

2. Section 226.35 is amended by revising paragraph (a)(1) and adding paragraph (b)(3)(v) to read as follows:

Subpart E—Special Rules for Certain Home Mortgage Transactions

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§ 226.35 Prohibited acts or practices in connection with higher-priced mortgage loans.

(a) Higher-priced mortgage loans—(1) For purposes of this section, except as provided in paragraph (b)(3)(v) of this section, a higher-priced mortgage loan is 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 by 3.5 or more percentage points for loans secured by a subordinate lien on a dwelling.

* * * * *

(b) * * *

(3) * * *

(v) "Jumbo" loans. For purposes of this § 226.35(b)(3), for a transaction with a principal balance at consummation that exceeds the maximum principal obligation in effect as of the date the transaction's interest rate is set for such a transaction to be eligible for purchase by Freddie Mac pursuant to Section 305(a)(2) of the Federal Home Loan Mortgage Corporation Act, 12 U.S.C. 1454(a)(2), the coverage threshold set forth in paragraph (a)(1) of this section for loans secured by a first lien on a dwelling shall be 2.5 or more percentage points greater than the applicable average prime offer rate.

* * * * *

3. In Supplement I to Part 226, under Section 226.35—Prohibited Acts or Practices in Connection With Higher-Priced Mortgage Loans, 35(b) Rules for higher-priced mortgage loans, 35(b)(3) Escrows, add an entry for 35(b)(3)(v) "Jumbo" loans to read as follows:

Supplement I to Part 226—Official Staff Interpretations

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Subpart E—Special Rules for Certain Home Mortgage Transactions

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Section 226.35—Prohibited Acts or Practices in Connection With Higher-Priced Mortgage Loans

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35(b) Rules for higher-priced mortgage loans.

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35(b)(3) Escrows.

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▶ 35(b)(3)(v) "Jumbo" loans.

1. Special threshold for "jumbo" loans. For purposes of the escrow requirement in § 226.35(b)(3) only, the coverage threshold stated in § 226.35(a)(1) for first-lien loans (1.5 or more percentage points greater than the average prime offer rate) does not apply to a loan with a principal balance that exceeds the current maximum loan amount for loans eligible to be purchased by Freddie Mac as of the date the transaction's rate is set. Under § 226.35(b)(3)(v), for such loans ("jumbo" loans), the threshold is 2.5 or more percentage points greater than the average prime offer rate. This higher threshold applies solely to whether a "jumbo" loan is subject to the escrow requirement of § 226.35(b)(3). The determination of whether "jumbo" loans are subject to the other protections in § 226.35, such as the ability to repay requirements under § 226.35(b)(1) and the restrictions on prepayment penalties under § 226.35(b)(2), is based on the 1.5 percentage point threshold stated in § 226.35(a)(1).

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By order of the Board of Governors of the Federal Reserve System, August 13, 2010.

Robert deV. Frierson, Deputy Secretary of the Board.

[FR Doc. 2010-20665 Filed 9-23-10; 8:45 am]

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