WHITEPAPER

Escrow Requirements under the Truth in Lending Act (Regulation Z)

BAI LEARNING & DEVELOPMENT

Introduction

In January 2013, the Consumer Financial Protection Bureau (CFPB) published a final rule that amends Regulation Z to implement certain amendments to the Truth in Lending Act (TILA) made by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). Regulation Z currently requires creditors to establish escrow accounts for higher-priced mortgage loans secured by a first lien on a principal dwelling. The new rule implements statutory changes made by the Dodd-Frank Act that lengthen the time that these mandatory escrow accounts be maintained.

The rule also exempts certain transactions from the statute's escrow requirement. The primary exemption applies to mortgage transactions extended by creditors that:

- operate predominantly in rural or underserved areas;
- originate a limited number of first-lien covered transactions;
- have assets below $2 billion; **and**
- do not maintain escrow accounts on mortgage obligations they currently service.

For some financial institutions this may mean a potential reduction in escrow requirements. However, make sure that before you make any changes you consider this and other information carefully.

This rule takes effect on June 1, 2013. BAI Learning & Development courseware will be updated to assist you with this new process. More updates will be provided as the effective date draws closer.

Summary of the Final Rule

The final rule has three main elements:

- As directed by the Dodd-Frank Act, the rule amends existing regulations that require creditors to establish and maintain escrow accounts for at least one year after originating a "higher-priced mortgage loan." The new rule requires escrow accounts be maintained for at least **five** years.

- The rule creates an exemption from the escrow requirement for small creditors that operate predominately in rural or underserved areas. To be eligible for the exemption, a creditor must:
  - make more than half of its first-lien mortgages in rural or underserved areas;
  - have an asset size less than $2 billion;
  - together with its affiliates, have originated 500 or fewer first-lien mortgages during the preceding calendar year; **and**
  - together with its affiliates, not escrow for any mortgage it or its affiliates currently services, except in limited instances.

Under the rule, eligible creditors do not need to establish escrow accounts for mortgages intended at consummation to be held in portfolio. However, creditors must establish accounts at consummation for mortgages that are subject to a forward commitment to be purchased by an investor that does not itself qualify for the exemption.

- The rule expands upon an existing exemption from escrowing for insurance premiums (though not for property taxes) for condominium units by extending the partial exemption to other situations in which an individual consumer's property is covered by a master insurance policy.

Escrow Provisions under the Dodd-Frank Act

The Dodd-Frank Act amended TILA to mandate escrow accounts for certain consumer credit transactions secured by a first lien on a consumer's principal dwelling.

The new language:

- establishes a five year minimum period for which escrows must be held for higher-priced mortgage loans;
- creates a rate threshold for determining whether escrow accounts are required for "jumbo loans," whose principal amounts exceed the maximum eligible for purchase by Freddie Mac; and
- adds two disclosure requirements concerning escrow accounts.

In addition, the Dodd-Frank Act provides the CFPB with authority to prescribe regulations that revise, add to, or subtract from the criteria that describe when an escrow account is required when it finds that such regulations are in the interest of the consumers and in the public interest.

Closer Analysis: Subsequent Disclosure Requirements

The CFPB has delayed the implementation of the disclosure requirements contained in title XIV of the Dodd-Frank Act. These disclosures will be built into the new combined Regulation Z/RESPA disclosures that are due later this year and will be enforced then.

"Jumbo Loans"
The Dodd-Frank Act substantially codifies Regulation Z's escrow requirement for higher-priced mortgage loans. The Dodd-Frank Act establishes a higher threshold above the average prime offer rate for determining when escrow accounts are required for transactions that exceed the maximum principal balance eligible for sale to Freddie Mac ("jumbo" transactions). Congress established a new threshold of 2.5 percentage points above the average prime offer rate for "jumbo" transactions. This was placed in the Regulation in 2011 and is now final.

Average Prime Offer Rate
The CFPB elected to avoid changing the regulatory language from the definition that has been in place for some time. The CFPB has, however, added a comment to clarify that the average prime offer rate in Regulation Z has the same meaning as in Regulation C (HMDA).

Escrow Requirement
As amended by the Dodd-Frank Act, TILA requires that an escrow account be established for any consumer credit transaction secured by a first lien on a consumer's principal dwelling under four specific circumstances in which any of the following apply:

- an escrow account is required by Federal or State law

- the transaction is made, guaranteed, or insured by a State or Federal agency
- where the transaction's annual percentage rate exceeds the average prime offer rate by prescribed amounts
- where an escrow account is "required pursuant to regulation"

For the purposes of this portion of the regulation, "escrow account" has the same meaning as under Regulation X (RESPA).

Exemptions – Loan Categories
Under existing regulations, certain categories of transactions are exempt from the escrow requirement, including:

- transactions to finance the initial construction of a dwelling
- temporary or "bridge" transactions with a term of twelve months or less
- reverse mortgage transactions, or a home equity line of credit
- cooperatives
- some condominiums and similar ownership types, such as Planned Unit Developments (PUDs)

The CFPB believes that because reverse mortgages are unique transactions that are currently addressed by another portion of Regulation Z, it is in the interest of consumers and the public interest to conduct further review of the reverse mortgage regulation and to consider whether new or different protections would be appropriate for reverse mortgages at a later date.

Exemptions – Institutions
As adopted by the Dodd-Frank Act, TILA authorizes the CFPB to exempt from the higher-priced mortgage loan escrow requirement a creditor that:

- operates predominantly in rural or underserved areas;
- together with all affiliates, has total annual mortgage loan originations that do not exceed a limit set by the CFPB;
- retains its mortgage obligations in portfolio; and
- meets any asset-size threshold and any other criteria as the CFPB may establish.

The CFPB adopted this section by providing that a transaction is exempt from the escrow account requirement otherwise applicable to a higher-priced mortgage loan if the creditor:

- in the preceding calendar year made more than 50 percent of its first-lien covered transactions in counties designated by the CFPB as "rural" or "underserved";
- together with all affiliates extended 500 or fewer first-lien covered transactions in the preceding calendar year; and
- has total assets that are less than $2 billion, adjusted annually for inflation.

Key Differences: A Closer Look
Definition - "Operates Predominantly in Rural or Underserved Areas"

Under TILA, to qualify for the exemption, a creditor must "operate predominantly in rural or underserved areas." The CFPB believes Congress enacted this exemption to ensure access to credit in rural and underserved areas where consumers may be able to obtain credit only from community banks or other small creditors. The "operates predominantly in" requirement serves to limit the exemption to these institutions. To remove this portion of the qualifications of the creditor would be to circumvent Congress's stated requirements. The CFPB believes that "predominantly"

indicates a portion greater than half, hence the regulatory requirement of more than 50 percent.

The Federal Reserve Board of Governors (Board) 2011 Escrows Proposal would have required creditors to track first-lien higher-priced mortgage loans by county, while the qualified mortgage proposal would have required creditors to track balloon-payment mortgages. Given that the underlying statutory language is the same in each instance and that tracking each type of mortgage separately would increase administrative burdens, the CFPB believes it is appropriate to base the threshold for both rules on the distribution of all first-lien "covered transactions" as defined by the regulation.

The CFPB believes that counting only first-lien transactions will facilitate compliance since both exemptions relate to first-lien transactions. Subordinate-lien, higher-priced mortgage loans are not required to establish escrow accounts. Only first-lien higher priced mortgage loans must establish escrow accounts.

Accordingly, the regulation provides that, during the preceding calendar year, a creditor must have made more than 50 percent of its total first-lien covered transactions in counties designated "rural" or "underserved" as defined by the regulation. The CFPB will publish a list of counties that qualify as rural or underserved annually. A more detailed explanation of these two terms is presented later in this whitepaper.

Total Annual Mortgage Originations

TILA provides that, to qualify for the exemption, a creditor, together with its affiliates, must have total annual mortgage originations that do not exceed a limit set by the CFPB.

The CFPB believes that the TILA requirement reflects a reality that larger creditors have the systems capability and operational scale to establish cost-efficient escrow accounts. Similarly, the CFPB believes the requirement reflects Congress's recognition that larger creditors who operate in rural or underserved areas should be able to make credit available without resorting to balloon-payment mortgages.

The CFPB conducted an analysis to determine the most appropriate thresholds. The CFPB ultimately decided to adopt a threshold of 500 or fewer annual originations of first-lien transactions. The CFPB believes that this threshold will provide greater flexibility and reduce concerns that the specific threshold that had been previously proposed would reduce access to credit by excluding creditors that need special accommodations in light of their capacity constraints. At the same time, the increase is not as dramatic as it may first appear because the CFPB's analysis of HMDA data suggests that even small creditors are likely to sell a significant number of their originations in the secondary market. The higher threshold will help ensure that creditors that are subject to the escrow requirement do in fact maintain portfolios of sufficient size to maintain the escrow accounts on a cost efficient basis over time.

Asset-Size Threshold

To qualify for the exemption, TILA provides that a creditor must meet any asset-size threshold established by the CFPB.

The CFPB is adopting an annual originations limit as contemplated by the statute. Given that limitation, restricting the asset size of institutions that can claim the exemption is of limited importance. Nonetheless, the CFPB believes that an asset-size limitation is still helpful because very large institutions should have sufficient resources to adapt their systems to make mortgages without a balloon payment and to establish and maintain escrow accounts even if the scale of their mortgage operations is relatively modest. An asset-size limitation can guard against circumvention of the rule if a larger institution were to elect to enter a rural area to make a limited number of higher-priced mortgage loans or balloon-payment mortgages.

The CFPB adopted language requires creditors to have total assets at the end of the preceding calendar year that are less than $2 billion. This threshold will adjust automatically each year based on the year-to-year change in the average of the Consumer Price Index for Urban Wage Earners and Clerical Workers (CPI-W), not seasonally adjusted, for each 12-month period ending in November, with rounding to the nearest million dollars. The commentary states this initial threshold and states that a creditor that had total assets below the threshold on December 31 of the preceding year satisfies this criterion for purposes of the exemption during the current calendar year. The CFPB will publish notice of each year's asset threshold by amending the comment.

Creditor and Affiliates Do Not Maintain Escrows
As adopted by the Dodd-Frank Act, TILA provides that, to qualify for the exemption, a creditor must meet any other criteria established by the CFPB consistent with the provisions of TILA. The Board's proposal would have required that, to obtain the exemption, the creditor and its affiliates not maintain an escrow account for any mortgage they currently service through at least such mortgage obligation's second installment due date. The Board used the second installment due date as a cutoff point because it recognized that a creditor may sometimes hold a mortgage obligation for a short period after consummation to take steps necessary before transferring and assigning the mortgage debt obligation to the intended investor. The Board recognized that the process of transferring and assigning the mortgage obligation could extend beyond the mortgage obligation's first payment due date, especially when the first payment is due shortly after consummation.

The CFPB adopted the Board's proposal, with the addition of two exceptions based on comments received. The CFPB agreed with the Board generally that creditors that currently provide escrow accounts can afford to establish and maintain escrow accounts for higher-priced mortgage loans. Thus, to qualify for the exemption, a creditor and its affiliates must not maintain escrow accounts for any extensions of consumer credit secured by real property or a dwelling that the creditor, or its affiliates, currently services through at least the second installment due date.

However, the CFPB agrees with commenters that those creditors that would otherwise qualify for the exemption but for their compliance with the current regulation, and creditors that establish escrow accounts as an accommodation to distressed consumers, should still be able to qualify for the exemption.

The commentary states that the limitation excluding creditors and their affiliates who currently maintain escrow accounts for other mortgage obligations they service applies only to mortgage obligations serviced at the time a transaction is consummated. Thus, the exemption still could apply even if the creditor or its affiliates previously established and maintained escrows for mortgage obligations that it no longer services.

However, if a creditor or an affiliate escrows for mortgage obligations currently serviced, those institutions are ineligible to invoke the escrows exemption until the escrow accounts are no longer maintained. The comment also clarifies that a creditor or its affiliate "maintains" an escrow account for a mortgage obligation only if it services the mortgage obligation at least through the due date of the second periodic payment under the terms of the legal obligation.

The commentary also clarifies that escrow accounts created by a creditor and its affiliates established between April 1, 2010 and June 1, 2013 are not counted for purposes of the regulation. In addition, the comment clarifies that creditors that continue to maintain escrow accounts that were established in that same timeframe until the termination of those escrow accounts will still qualify for the exemption, so long as they or their affiliates do not establish escrow accounts for other mortgage obligations that the creditor and its affiliates service after June 1, 2013 and they otherwise qualify under the regulation. Escrow accounts established after consummation for distressed consumers are not considered to be maintaining escrow accounts for purposes of the regulation although creditors

that establish escrow accounts after consummation as a regular business practice are considered to be maintaining escrow accounts and cannot qualify for the exception.

Drill Down: “Rural” and “Underserved”
As adopted in the Dodd-Frank Act, TILA requires, among other criteria for the escrow exemption, that the creditor operate predominantly in “rural” and “underserved” areas, but does not define either term. The Board proposed separate definitions for “rural” and “underserved,” respectively.

The CFPB adopted the Board’s approach, which establishes a definition of rural that is separate from underserved. Thus, creditors’ activity in either type of area will count toward their eligibility for the escrow exemption.

“Rural”
The Board’s proposed definition of rural for purposes the escrow exemptions would have relied upon the USDA’s Economic Research Service’s Urban Influence Codes (UICs), which in turn are based on the definitions of “metropolitan statistical area” and “micropolitan statistical area.”

The CFPB determined that a broader definition of “rural” was appropriate to ensure access to credit. The CFPB believes that all “non-core” counties should be encompassed in the definition of rural, including counties adjacent to a metropolitan area of at least one million residents or a county with a town of at least 2,500 residents. The CFPB also believes that micropolitan areas that are not adjacent to a metropolitan area should be included within the definition of rural as these areas are not located adjacent to metropolitan areas that are served by many creditors. These counties have significantly fewer creditors originating higher-priced mortgage loans and balloon-payment mortgages than other counties. Including these counties within the definition of rural would result in 9.7 percent of the U.S. population being located within rural areas. Under this definition, only counties in metropolitan areas or in micropolitan areas adjacent to metropolitan areas would be excluded from the definition of rural.

The final rule provides that a county is rural if it is neither in a metropolitan statistical area nor in a micropolitan statistical area that is adjacent to a metropolitan statistical area. The CFPB intends to continue over time studying possible changes to provide an appropriate balance to preserve access to credit and create a system that is easy for creditors to implement.

“Underserved”
The purpose of the exemption is to permit creditors to continue to offer credit to consumers rather than to refuse to make higher-priced mortgage loans if such creditors’ withdrawal would significantly limit consumers’ ability to obtain mortgage credit. In light of this rationale, the CFPB believes that “underserved” should be implemented in a way that protects consumers from losing meaningful access to mortgage credit and that it is appropriate to focus the definition on identifying areas where the withdrawal of a creditor from the market could leave no meaningful competition for consumers’ mortgage business.

The CFPB notes that the final rule’s expanded definition of “rural,” as discussed above, will also address concerns about access to credit in many areas. Accordingly, the CFPB adopted regulatory language to define a property as “underserved” if it is located in a county where no more than two creditors extend covered transactions secured by a first lien five or more times in that county during a calendar year. As adopted, the regulation also expressly states that the numbers of creditors and of their originations in counties for purposes of this definition is as reported in HMDA data for the year in question.

The CFPB adopted this definition based on HMDA data to provide an objective, easily administered rule and one that is consistent with the purpose of preserving credit access in underserved areas. Given that many smaller creditors may not be subject to HMDA reporting requirements, the CFPB

recognizes that many counties may be underserved under the definition being adopted because it is based on HMDA data, yet additional information (if it were available) could reveal that more than two creditors are significantly active in such counties. The CFPB may examine further whether a refinement to the underserved definition is warranted.

Commentary Guidance on “Rural” and “Underserved” Definitions
The commentary states that the CFPB will annually update on its website a list of counties deemed rural or underserved under the definitions. The commentary provides that the CFPB also will publish a list of only those counties that are rural but not also underserved, to facilitate compliance with the regulation. As this final rule takes effect on June 1, 2013, the CFPB expects to publish lists applicable for the current year within approximately four to six weeks after publication of this final rule before this final rule takes effect.

Portfolio Retention and Forward Commitments

As established by the Dodd-Frank Act, TILA requires that the exemption from the escrow requirements apply only where a creditor “retains its mortgage loan originations in portfolio” and meets the other statutory requirements.

The Board considered requiring that a transaction be held in portfolio after consummation as a condition of the escrows exemption, but it concluded that this approach would have raised operational problems. Whether a mortgage obligation is held in portfolio can be determined only after consummation, but a creditor making a higher-priced mortgage loan must know by consummation whether it is subject to the escrow requirement. The Board expressed concern that requiring an escrow account to be established sometime after consummation if the creditor in fact sells the mortgage obligation could put a significant burden on consumers who may not have the money available to make a significant advance payment.

In contrast, the Board reasoned that the forward commitment test would be easy to apply at consummation, and would be unlikely to be circumvented by small creditors because they would be reluctant to extend credit for transactions they do not intend to keep in portfolio unless they have the assurance of a committed buyer before extending the credit. Thus, the proposal would have served as a means of indirectly limiting the exemption to mortgage obligations that are to be held in portfolio.

After reviewing the comments received, the CFPB believes that the Board’s proposal is an appropriate method to implement the requirements of TILA, since both creditor and consumer benefit if an escrow account is established at consummation of the transaction rather than months or years later. Indeed, allowing a consumer to avoid having to make a single large lump-sum payment after consummation is part of the basic purpose of establishing an escrow account. Accordingly, the CFPB is following the approach in the Board’s proposal by adopting language to require that for a higher-priced mortgage loan to be exempt from the requirements, the higher-priced mortgage loan must not be subject to a forward commitment to be acquired by a creditor.

The commentary clarifies that a higher-priced mortgage loan that is subject to a forward commitment is subject to the escrow requirement, whether the forward commitment refers to the specific transaction or the higher-priced mortgage loan meets prescribed criteria of the forward commitment, along with an example.

Cancellation
Under TILA, a creditor or servicer of a higher-priced mortgage loan must maintain an escrow account for a minimum of five years following consummation, unless the underlying debt obligation is terminated earlier under certain prescribed circumstances. In addition, even after five years have elapsed, TILA provides that an escrow account shall remain in existence unless and until the

consumer is current on the obligation and has accrued sufficient equity in the dwelling securing the consumer credit transaction “so as to no longer be required to maintain private mortgage insurance.”

Under the Homeowners Protection Act of 1998 (HPA), the consumer may initiate cancellation of private mortgage insurance (PMI) once the outstanding balance of the mortgage obligation is first scheduled to reach 80 percent of the original value of the property, regardless of the outstanding balance, based on the amortization schedule or actual payments. In addition, servicers must automatically terminate PMI for residential mortgage transactions on the earliest date that the principal balance of the mortgage is first scheduled to reach 78 percent of the original value of the secured property securing the mortgage obligation, where the consumer is current.

The final rule contains language describing the equity necessary for cancellation as an unpaid principal balance that is less than 80 percent of the original value of the property securing the underlying debt obligation. Additionally, the CFPB adopted the Board’s proposed comment to clarify that termination of the underlying credit obligation could include, among other things, repayment, refinancing, rescission, and foreclosure.

The commentary also clarifies that the regulation does not affect the right or obligation of a creditor or servicer, pursuant to the terms of the legal obligation or applicable law, to offer or require an escrow account after the minimum period dictated by the regulation. Finally, the commentary notes that the term “original value” means the lesser of the sales price reflected in the sales contract for the property, if any, or the appraised value of the property at the time the transaction was consummated.

Evasion; Open-End Credit

The regulation parallels existing language that prohibits a creditor from structuring a home-secured transaction as an open-end plan to evade the requirements of the regulation in connection with credit secured by a consumer’s principal dwelling that does not meet the definition of open-end credit in the regulation.

Effective Date

The rule is effective for all applications dated June 1, 2013 or later. The final rule does not expand either the universe of transactions to which the escrow requirements apply or the universe of creditors subject to them. The new exemption adopted by this final rule for higher-priced mortgage loans extended by small creditors that operate in rural or underserved areas represents a reduction in compliance burden for creditors that meet the exemption’s prerequisites.

Moreover, the expansion of the partial exemption for condominiums to other property types where the governing association has an obligation to maintain a master policy insuring all dwellings, such as planned unit developments, also represents additional compliance burden relief for creditors.

The CFPB believes that both the burden relief for certain small creditors and the expanded protection for consumers of maintaining escrows for four additional years warrant expedited implementation to avoid any unnecessary delay of either.

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