



INFOBYTES SPECIAL ALERT:

DETAILED ANALYSIS OF CFPB'S FINAL ESCROW RULE

FEBRUARY 15, 2013

On January 10, 2013, the Consumer Financial Protection Bureau (the "Bureau") issued its final rule (the "Rule" or "Escrow Rule") on escrow account requirements for first-lien higher-priced mortgage loans.¹ The Rule amends existing escrow requirements and exemptions for such loans by, among other things, extending the required period of time during which escrow accounts must be maintained from one to five years, and creating a new exemption for small creditors that operate predominantly in rural or underserved areas. This memorandum provides a detailed summary and analysis of the Rule, which becomes effective June 1, 2013 and applies to loans for which creditors receive applications on or after this date.²

I. Scope and Overview

The Rule applies to "higher-priced mortgage loans" ("HPMLs"), which are defined in the Rule as closed-end consumer credit transactions secured by the consumer's principal dwelling with an annual percentage rate that exceeds the average prime offer rate³ for a comparable transaction as of the date the interest rate is set:

¹ Consumer Financial Protection Bureau, Final Rule, Escrow Requirements under the Truth in Lending Act (Regulation Z) (Jan. 10, 2013), http://files.consumerfinance.gov/f/201301_cfpb_final-rule_escrow-requirements.pdf [hereinafter, "*Final Release*"]. Unless otherwise specified, this Alert hereafter uses shortened citations such as "§ 35" to mean "12 C.F.R. § 1026.35." Similarly, unless otherwise specified, the shortened citation "Cmt. 35," and the term "Comment" refer to the Official Commentary to 12 C.F.R. § 1026.35. We also distinguish between "New § 35" — which refers to the provisions of § 35 that will become effective June 1, 2013—and "Current § 35."

² Specifically, the *Final Release* states that "[t]he rule is effective June 1, 2013. Its requirements apply to transactions for which creditors receive applications on or after that date." *Final Release* at 1. This language raises some questions – for example, would the Rule apply if the application is received prior to June 1 but the transaction is consummated after this date? The answer may significantly impact creditors who hope to qualify for the new exemption for small creditors operating in rural or underserved areas (discussed below). If those creditors will be required to establish escrow accounts after June 1 under the old rule, then they may not meet one of the conditions necessary to qualify for the exemption.

³ The Rule does not amend the definition of "[a]verage prime offer rate," which continues to be defined as "an annual percentage rate that is derived from average interest rates, points, and other loan pricing terms currently offered to consumers by a representative sample of creditors for mortgage transactions that have low-risk pricing characteristics. The Bureau publishes average prime offer rates for a broad range of types of transactions in a table updated at least weekly as well as the methodology the Bureau uses to derive these rates." New § 35(a)(2).

A new Comment clarifies that the average prime offer rate "has the same meaning in § 1026.35 as in Regulation C, 12 CFR part 1003." New cmt. 35(a)(2)-3. In addition, "[g]uidance on the average prime offer rate under § 1026.35(a)(2), such as when a transaction's rate is set and determination of the comparable transaction, is

- (i) By 1.5 or more percentage points for loans secured by a first lien with a principal obligation at consummation that does not exceed the limit in effect as of the date the transaction's interest rate is set for the maximum principal obligation eligible for purchase by Freddie Mac;
- (ii) By 2.5 or more percentage points for loans secured by a first lien with a principal obligation at consummation that exceeds the limit in effect as of the date the transaction's interest rate is set for the maximum principal obligation eligible for purchase by Freddie Mac; or
- (iii) By 3.5 or more percentage points for loans secured by a subordinate lien.⁴

This definition is a modified version of the current definition of an HPML: it expressly limits HPMLs to “closed-end” consumer credit transactions⁵ and includes the separate coverage threshold for “jumbo” loans. Currently, this threshold is applicable only for purposes of § 35's escrow requirements; however, pursuant to the Rule, it will be part of the definition of an HPML generally. The Rule also recodifies existing exclusions from the definition of an HPML – *i.e.*, exclusions for construction loans, bridge loans, and reverse mortgage transactions – in a new subsection 1026.35(b)(2) that sets forth exemptions from the Rule's escrow requirements.

As discussed in greater detail below, the Rule has three primary components:

- It amends existing requirements for maintaining escrow accounts in connection with first-lien HPMLs, and extends the required period of time during which such accounts must be maintained from one to five years;
- It creates a new exemption from the escrow account requirement for small creditors that operate predominantly in rural or underserved areas; and
- It expands an existing exemption from escrowing of insurance premiums for loans secured by condominiums to include other types of property covered by a master insurance policy.

provided in the official commentary under Regulation C, the publication entitled ‘A Guide to HMDA Reporting: Getting it Right!’, and the relevant ‘Frequently Asked Questions’ on Home Mortgage Disclosure Act (HMDA) compliance posted on the FFIEC's website at <http://www.ffiec.gov/hmda>.” *Id.*

⁴ New § 35(a)(1). This definition is referenced in the Bureau's Ability-to-Repay final rule, which prohibits covered transactions from including a prepayment penalty unless: “(i) The prepayment penalty is otherwise permitted by law; and (ii) The transaction: (A) Has an annual percentage rate that cannot increase after consummation; (B) Is a qualified mortgage under paragraph (e)(2), (e)(4), or (f) of this section; and (C) Is not a higher-priced mortgage loan, as defined in § 1026.35(a).” 12 C.F.R. § 1026.43(g) (emphasis added).

⁵ Because HPMLs are defined to include only “closed-end” loans, the Rule does not contain a separate exemption for home equity lines of credit.

One less obvious change made by the Rule is its deletion of the existing repayment ability requirement and prepayment penalty restriction in current § 1026.35(b)(1) and (2). As explained by the Bureau, “[d]ue to amendments to TILA mandated by the Dodd-Frank Act ... existing HPML rules on repayment ability (§ 1026.35(b)(1)) and prepayment penalties (§ 1026.35(b)(2)) will be eliminated from the HPML rules in § 1026.35. New rules on repayment ability and prepayment penalties are incorporated into the Bureau’s 2013 ATR Final Rule and final rules on ‘high-cost’ mortgages.”⁶ The Bureau’s ATR and HOEPA rules, however, become effective January 10, 2014, over seven months after the effective date of the Escrow Rule. It appears that neither the current nor the new repayment ability and prepayment penalty rules would apply to HPMLs during this interim period.

In addition, the Rule does not implement TILA § 129D, subsections (h) and (j), which impose certain escrow account disclosure requirements, including in connection with pre- and post-consummation waivers of escrow. The Bureau’s proposal to integrate RESPA and TILA disclosures incorporated (and proposed a temporary exemption from) the pre-consummation disclosure requirements under § 129D(h) and (j), but not the disclosure regarding waiver of an existing escrow account following consummation of the loan.⁷ However, on November 16, the Bureau issued a final rule delaying the implementation of both the pre- and post-consummation escrow disclosures until a final RESPA/TILA rule takes effect.⁸

Finally, the Bureau reserved § 35(c) of the Rule for purposes of “implementing section 1471 of the Dodd- Frank Act, which creates new TILA section 129H to establish certain appraisal requirements applicable to ‘higher-risk mortgages.’”⁹ Section 35(c) has now been finalized as part of the 2013 Interagency Appraisals Final Rule.¹⁰ It sets forth appraisal requirements for HPMLs, and generally prohibits creditors from extending an HPML without obtaining a written appraisal by a certified or licensed appraiser who has conducted a physical visit of the interior of the property.¹¹

⁶ Interagency Final Rule on Appraisals for Higher-Priced Mortgage Loans (Jan. 18, 2013) at 21, http://files.consumerfinance.gov/f/201301_cfpb_final-rule_tila-appraisals.pdf.

⁷ Consumer Financial Protection Bureau, Proposed Rule, Integrated Mortgage Disclosures Under the Real Estate Settlement Procedures Act (Regulation X) and the Truth In Lending Act (Regulation Z) (Aug. 23, 2012), <https://www.federalregister.gov/articles/2012/08/23/2012-17663/integrated-mortgage-disclosures-under-the-real-estate-settlement-procedures-act-regulation-x-and-the>.

⁸ Consumer Financial Protection Bureau, Final Rule, Delayed Implementation of Certain New Mortgage Disclosures (Nov. 16, 2012), http://files.consumerfinance.gov/f/201211_cfpb_final-rule_title-XIV-disclosures-extension.pdf.

⁹ *Final Release* at 61.

¹⁰ Interagency Final Rule on Appraisals for Higher-Priced Mortgage Loans (Jan. 18, 2013), http://files.consumerfinance.gov/f/201301_cfpb_final-rule_tila-appraisals.pdf.

¹¹ § 35(c), as amended by the 2013 Interagency Appraisals Final Rule.

II. Current Escrow Requirements for HPMLs

TILA's implementing Regulation Z currently requires creditors to establish an escrow account¹² before consummation of an HPML¹³ secured by a first lien on a principal dwelling, unless the HPML is secured by shares in a cooperative.¹⁴ The escrow account must be established for payment of both property taxes and premiums for mortgage-related insurance required by the creditor, with one limited exception for certain condominium units: if the loan is secured by a condominium unit where the condominium association is obligated to maintain a master policy insuring condominium units, then the escrow account need only be maintained for payment of property taxes—insurance premiums need not be included in the escrow account.¹⁵

Stated differently, the current rules do not require creditors to establish escrow accounts for (1) HPMLs secured by shares in a cooperative, (2) mortgage-related insurance required by the creditor if a condominium association is required to maintain a master insurance policy covering the unit securing the loan, or (3) mortgage-related insurance that the creditor does not require in connection with the credit transaction, such as earthquake insurance or debt-protection insurance.¹⁶

¹² An "escrow account" has the same meaning as under RESPA's implementing Regulation X, 12 C.F.R. § 1024.17(b). Current § 35(b)(3)(iv).

¹³ Current § 35(a)(1) defines an HPML as follows: "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." Under current § 35(b)(3)(v), for purposes of the escrow account requirement, "for a transaction with a principal obligation at consummation that exceeds the limit in effect as of the date the transaction's interest rate is set for the maximum principal obligation eligible for purchase by Freddie Mac, 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." See also current cmt. 35(b)(3)(v)-1. The annual percentage rate must be compared to the average prime offer rate as of the date the transaction's interest rate is set (or "locked") before consummation. Current cmt. 35(a)(2)-3. If the rate changes before consummation, the last rate set should be used. *Id.*

An HPML "does not include a transaction to finance the initial construction of a dwelling, a temporary or 'bridge' loan with a term of twelve months or less, such as a loan to purchase a new dwelling where the consumer plans to sell a current dwelling within twelve months, a reverse-mortgage transaction subject to § 1026.33, or a home equity line of credit subject to § 1026.40." Current § 35(a)(3). However, a creditor cannot "structure a home-secured loan as an open-end plan to evade the requirements of [§1026.35]." Current § 35(b)(4).

¹⁴ Current § 35(b)(3)(i), (ii)(A). The term "Principal dwelling" includes structures that are classified as personal property under State law, such as mobile homes, boats, or trailers used as the consumer's principal residence. Current cmt. 35(b)(3)-1.

¹⁵ Current § 35(b)(3)(i), (ii)(B). Examples of mortgage-related insurance required by the creditor include "insurance against loss of or damage to property, or against liability arising out of the ownership or use of the property, or insurance protecting the creditor against the consumer's default or other credit loss." Current § 35(b)(3)(i).

¹⁶ Current § 35(b)(3)(ii); current cmt. § 35(b)(3)-3.

Current rules require the escrow account to be maintained for at least one year. Specifically, a creditor or servicer “may permit a consumer to cancel the [required] escrow account ... only in response to a consumer’s dated written request to cancel the escrow account that is received no earlier than 365 days after consummation.”¹⁷

III. Primary Elements of the Rule

A. Amends Requirements for Maintaining an Escrow Account in Connection with a First-Lien HPML

The Rule increases the length of time during which creditors are required to maintain escrow accounts for first-lien HPMLs from one to five years. Specifically, it provides that a creditor or servicer may cancel an escrow account required under the Rule “only upon the earlier of: (A) Termination of the underlying debt obligation;¹⁸ or (B) Receipt no earlier than five years after consummation of a consumer’s request to cancel the escrow account.”¹⁹

However, even if five years have elapsed since consummation, and the creditor or servicer receives the consumer’s cancellation request, the escrow account may not be cancelled unless (1) “The unpaid principal balance is less than 80 percent of the original value of the property securing the underlying debt obligation;” and (2) “The consumer currently is not delinquent or in default on the underlying debt obligation.”²⁰

For purposes of this restriction, the Comments define the term “original value” as “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.”²¹ In addition, the Comments explain that when determining whether the unpaid principal balance is lower than 80% of the original value, the creditor or servicer must account for any subordinate lien “of which it has reason to know.” Unless the creditor or servicer has actual knowledge to the contrary, it may rely on the consumer’s written certification that the property is unencumbered by a subordinate lien.²²

The Comments also clarify that the requirement to maintain an escrow account for at least five years in connection with a first-lien HPML “does not affect a creditor’s right or obligation, pursuant to the terms of the legal obligation or applicable law, to offer or require an

¹⁷ Current § 35(b)(3)(iii).

¹⁸ “Methods by which an underlying debt obligation may be terminated include, among other things, repayment, refinancing, rescission, and foreclosure.” New cmt. 35(b)(3)-1.

¹⁹ New § 35(b)(3)(i).

²⁰ New § 35(b)(3)(ii).

²¹ New cmt. 35(b)(3)-3.

²² *Id.*

escrow account thereafter.”²³ Nor does it affect “a creditor’s ability, right, or obligation, pursuant to the terms of the legal obligation or applicable law, to offer or require an escrow account for a transaction that is not subject to” the escrow account requirement.²⁴

B. New Exemption for Small Creditors Operating in Rural or Underserved Areas

1. Key Terms

As noted above, the Rule recodifies existing exclusions from the definition of an HPML in a new subsection 1026.35(b)(2) that sets forth exemptions from the Rule’s escrow account requirements.²⁵ The Rule also creates a new exemption from these requirements for certain creditors operating in “rural” or “underserved” counties. As an initial matter, the applicability of this exemption depends in part on:

(1) The number of “Covered transactions” originated by the creditor and its affiliates. “Covered transactions” are defined in the Bureau’s Ability-to-Repay final rule as consumer credit transactions that are secured by a dwelling (including any real property attached to a dwelling) other than an exempt transaction.²⁶ Exempt transactions include:

- A home equity line of credit subject to § 1026.40;
- A mortgage transaction secured by a consumer’s interest in a timeshare plan, as defined in 11 U.S.C. 101(53(D));
- A reverse mortgage subject to § 1026.33;
- A temporary or “bridge” loan with a term of 12 months or less, such as a loan to finance the purchase of a new dwelling where the consumer plans to sell a current dwelling within 12 months or a loan to finance the initial construction of a dwelling; and
- A construction phase of 12 months or less of a construction-to-permanent loan.;²⁷ and

²³ New cmt. 35(b)(3)-2.

²⁴ New cmt. 35(b)(1)-3.

²⁵ The new Comments also provide guidance on the applicability of the Rule’s exemption for transactions to finance the initial construction of a dwelling, explaining that while § 35 does not apply to such transactions, it “may apply ... to permanent financing that replaces a construction loan, whether the permanent financing is extended by the same or a different creditor.” The Comments also discuss the initial determination of whether a construction-permanent loan constitutes an HPML. To the extent the transaction is determined to be an HPML, “only the permanent phase is subject to the requirement ... to establish and maintain an escrow account, and the period for which the escrow account must remain in place ... is measured from the time the conversion to the permanent phase financing occurs.” New cmt. 35(b)(2)(i)-1.

²⁶ 12 C.F.R. § 1026.43(b).

²⁷ 12 C.F.R. § 1026.43(a).

- (2) Whether the creditor operates predominantly in “rural” and “underserved” counties. A “rural” county is a county that “is neither in a metropolitan statistical area nor in a micropolitan statistical area that is adjacent to a metropolitan statistical area, as those terms are defined by the U.S. Office of Management and Budget and applied under currently applicable Urban Influence Center Codes (UICs), established by the U.S. Department of Agriculture’s Economic Research Services (USDA-ERS).”²⁸ A county is considered “underserved” if Home Mortgage Disclosure Act (HMDA) data for the year indicates that “no more than two creditors extend covered transactions... secured by a first lien five or more times in the county.”²⁹ The Bureau determines annually which counties are rural or underserved and publishes a list of those counties to enable creditors to determine whether they meet this condition for the exemption. Creditors may rely on this list as a safe harbor.³⁰

2. Four Conditions

Pursuant to the new exemption, a creditor is not required to establish an escrow account for taxes and insurance for an HPML if all four of the following conditions are satisfied when the loan is consummated:

- (1) “During the preceding calendar year, the creditor [must have] extended more than 50 percent of its total covered transactions..., secured by a first-lien, on properties that are located in counties designated either ‘rural’ or ‘underserved’ by the Bureau.”³¹ As noted in the Comments, a creditor meets this criterion in 2014 if, for example, it originated 90 first-lien covered transactions in 2013 and at least 46 of those transactions were secured by first liens on properties in “rural” or “underserved” counties;³²
- (2) The creditor and its affiliates together must have originated 500 or fewer covered transactions secured by a first lien during the preceding calendar year;³³
- (3) “As of the end of the preceding calendar year, the creditor must have had total assets of less than \$2,000,000,000” (adjusted annually “based on the year-to-year change in the

²⁸ New § 35(b)(2)(iv)(A). Note that the definition of “rural” is broader than that initially proposed. *Final Release* at 52. However, the Bureau has indicated that this may only be an initial interpretation. *Id.* at 54. It is planning to study the “possible selective use of the Rural Housing Loan program definitions and tools provided on the USDA website to determine whether a particular property is located within a ‘rural’ area.” *Id.* at 53.

²⁹ New § 35(b)(2)(iv)(B). However, “[t]he Bureau may examine further whether a refinement to the underserved definition is warranted.” *Final Release* at 55.

³⁰ New § 35(b)(2)(iv).

³¹ New § 35(b)(2)(iii)(A) (emphasis added).

³² New cmt. 35(b)(2)(iii)-1.i.

³³ New § 35(b)(2)(iii)(B).

average of the Consumer Price Index for Urban Wage Earners and Clerical Workers, not seasonally adjusted, for each 12-month period ending in November, with rounding to the nearest million dollars”).³⁴ For example, a creditor with less than \$2,000,000,000 in assets on December 31, 2012 satisfies this criterion for the exemption during 2013. The Bureau will amend Comment § 35(b)(2)(iii) each year to reflect each year’s asset threshold;³⁵ and

- (4) The creditor and its affiliates must not maintain an escrow account of the type described in new § 35(b)(1) “for any extension of consumer credit secured by real property or a dwelling that the creditor or its affiliate currently services, other than:
- a. [e]scrow accounts established for first-lien [HPMLs] on or after April 1, 2010, and before June 1, 2013; or
 - b. [e]scrow accounts established after consummation as an accommodation to distressed consumers to assist such consumers in avoiding default or foreclosure.”³⁶

The Comments clarify that the creditor satisfies this fourth condition even if it previously maintained escrow accounts, as long as it no longer maintains any accounts other than those established for first-lien HPMLs on or after April 1, 2010, and before June 1, 2013, or as an accommodation to distressed consumers. However, a creditor and its affiliate are ineligible for the exemption once the “creditor or its affiliate begins escrowing for loans currently serviced [other than as provided in the exceptions]...while such escrowing continues.” A “creditor or its affiliate ‘maintains’ an escrow account only if it services a mortgage loan for which an escrow account has been established at least through the due date of the second periodic payment under the terms of the legal obligation.”³⁷ Thus, a creditor that transfers and assigns a mortgage prior to the second periodic payment is not “maintaining” an escrow account for the loan for purposes of this fourth condition, even if one was established prior to consummation.

The Comments also clarify the exception for escrow accounts established to accommodate distressed consumers, explaining that “[d]istressed consumers are consumers who are working with the creditor or servicer to attempt to bring the loan into a current status through a modification, deferral, or other accommodation to the consumer.” If a creditor or its affiliates

³⁴ New § 35(b)(2)(iii)(C) (emphasis added).

³⁵ New cmt. 35(b)(2)(iii)-1.ii. We note that the Bureau’s Ability-to-Repay final rule provides “Qualified Mortgage” status to certain balloon-payment loans originated by creditors that meet the first three conditions of the Rule’s new exemption for small creditors that operate predominantly in rural or underserved areas. *See* 12 C.F.R. § 1026.43(f).

³⁶ New § 35(b)(2)(iii)(D) (emphasis added).

³⁷ New cmt. 35(b)(2)(iii)-1.iv.

establish escrow accounts after consummation as a regular business practice, regardless of whether the consumers are in distress, then they do not qualify for this exception.³⁸

3. Forward Commitments

Notwithstanding the foregoing, even if a creditor meets all four conditions under the new exemption, the exemption does not apply to (and, therefore, an escrow account must be established for) first-lien HPMLs that will be acquired by a purchaser pursuant to a forward commitment unless (a) the purchaser is also eligible for the exemption, or (b) the transaction is otherwise exempt.³⁹ If neither condition is satisfied, the escrow requirement applies to any such transaction regardless of “whether the forward commitment provides for the purchase and sale of the specific transaction or for the purchase and sale of mortgage obligations with certain prescribed criteria that the transaction meets.”⁴⁰

C. Expands Exemption for Transactions Involving Properties Covered by Master Insurance Policies

The Rule expands a partial exemption for transactions involving condominiums covered by a master insurance policy to include planned unit developments (“PUDs”) and other similar property types. Under the Rule, a creditor must “escrow for payment of property taxes for all first-lien [HPMLs] secured by condominium, [PUDs], or similar dwellings or units regardless of whether the creditor escrows for insurance premiums for such dwellings or units.”⁴¹ However, insurance premiums are not required to be “included in escrow accounts for loans secured by dwellings in condominiums, [PUDs], or other common interest communities in which ownership requires participation in a governing association, where the governing association has an obligation to the dwelling owners to maintain a master policy insuring all dwellings.”⁴² Thus, for example, a transaction secured by a unit in a PUD need not include escrows for insurance if the PUD’s governing association is required maintain such a master insurance policy.⁴³ If a property has multiple governing associations, the partial exemption applies to each master insurance policy obtained by the governing associations to the extent each governing association is required to maintain the master insurance policy at issue.⁴⁴

³⁸ New cmt. 35(b)(2)(iii)(D)(2)-1.

³⁹ New § 35(b)(2)(v); new cmt. 35(b)(2)(v)-1.

⁴⁰ New cmt. 35(b)(2)(v)-1.

⁴¹ New cmt. 35(b)(2)(ii)-1.

⁴² New § 35(b)(2)(ii).

⁴³ New cmt. 35(b)(2)(ii)-2.

⁴⁴ New cmt. 35(b)(2)(ii)-3.

* * *

Questions regarding the matters discussed in this Alert may be directed to any of our lawyers listed below, or to any other BuckleySandler attorney with whom you have consulted in the past.

- Jeffrey P. Naimon, (202) 349-8030, jnaimon@buckleysandler.com
- Clinton R. Rockwell, (310) 424-3901, crockwell@sandler.com
- Joseph J. Reilly, (202) 349-7965, jreilly@buckleysandler.com
- John P. Kromer, (202) 349-8040, jkromer@buckleysandler.com
- Joseph M. Kolar, (202) 349-8020, jkolar@buckleysandler.com
- Jeremiah S. Buckley, (202) 349-8010, jbuckley@buckleysandler.com