

Federal Reserve Bank of San Francisco  
101 Market Street, San Francisco, California 94105

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To State Member Banks, Bank  
Holding Companies, Financial Holding  
Companies, and Foreign Bank Offices  
in the Twelfth Federal Reserve District

**CA 09-12: Short-Term Balloon Loans and Regulation Z Repayment Ability Requirement for Higher-Priced Mortgage Loans**

This letter provides answers to frequently asked questions regarding compliance with Regulation Z's repayment ability rule for higher-priced balloon mortgage loans with terms of less than 7 years.<sup>1</sup> In 2008, the Board revised Regulation Z, which implements the Truth in Lending Act and the Home Ownership and Equity Protection Act, to prohibit creditors from making higher-priced mortgage loans "based on the value of the consumer's collateral without regard to the consumer's repayment ability as of consummation, including the consumer's current and reasonably expected income, employment, assets other than the collateral, current obligations, and mortgage-related obligations."<sup>2</sup> This repayment ability rule and other consumer protections for mortgage loans took effect for applications received on or after October 1, 2009.

A creditor has a presumption of compliance with the repayment ability rule if the creditor follows certain procedures, including verifying the borrower's income.<sup>3</sup> Creditors extending balloon loans with terms of 7 years or more can have a presumption of compliance if the procedures are followed and if so, the creditor need not consider the borrower's ability to repay the balloon payment. However, for some products a creditor cannot have a presumption of compliance even if it follows the specified procedures—these products include balloon loans with terms of less than 7 years ("short-term balloon loans").<sup>4</sup> Exclusion of short-term balloon loans from the presumption of compliance has led creditors to ask how they can make these loans and comply with the repayment ability rule.

**Frequently Asked Questions and Answers**

**1. Question:** Does the rule prohibit short-term balloon loans that are higher-priced mortgage loans?

**Answer:** No. However, the creditor must use prudent underwriting standards and, after considering consumers' income, employment, obligations and assets other than the collateral, the creditor should determine that the value of the collateral (the home) is not the basis for repaying the obligation (including the balloon payment).

**2. Question:** Does that mean the creditor must verify that the consumer has assets and/or income at the time of consummation that would be sufficient to pay the balloon payment when it comes due?

**Answer:** No, such a requirement would effectively ban short-term balloon loans. If the Board had intended to ban these products it would have done so explicitly.

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<sup>1</sup> A closed-end loan is a higher-priced mortgage loan if it is secured by a first lien on the consumer's principal dwelling with an APR that exceeds the "average prime offer rate" by 1.5 or more percentage points; loans secured by a subordinate lien on the consumer's principal dwelling are higher-priced mortgage loans if the APR exceeds the "average prime offer rate" by 3.5 or more percentage points. For more information about the "average prime offer rate" and higher-priced mortgage loans, see 12 CFR § 226.35.

<sup>2</sup> 12 CFR § 226.34(a)(4).

<sup>3</sup> 12 CFR § 226.34(a)(4)(iii).

<sup>4</sup> If a creditor is unconditionally obligated to renew a balloon loan, the creditor may use the full term of the renewal to determine whether the balloon loan is excluded from the presumption of compliance. See Official Staff Commentary, 12 CFR §§ 226.34(a)(4)(iv)-2 and 226.17(c)(1)-11.

3. **Question:** What must the creditor do, then, to verify the borrower's ability to repay a short-term balloon loan?

**Answer:** In addition to verifying the consumer's ability to make regular monthly payments, a creditor should verify that the consumer would likely be able to satisfy the balloon payment obligation by refinancing the loan or through income or assets other than the collateral.

4. **Question:** How does the creditor verify, when it originates a short-term balloon loan, whether the consumer could qualify for a refinancing before the balloon payment is due?

**Answer:** The creditor has an affirmative duty to engage in prudent underwriting.<sup>5</sup> Thus, the creditor should consider factors such as the loan-to-value ratio and the borrower's debt-to-income ratio or residual income—all as of the time of consummation. A borrower with a high debt-to-income ratio, and/or with little or no equity in the property, will be less likely to be able to refinance the loan before the balloon payment comes due than a borrower with lower debt-to-income and loan-to-value ratios. The creditor is not required to predict the consumer's future financial circumstances, interest rate environment, and home value.

### **Additional Information**

All circulars and documents are available on the Internet through the Federal Reserve Bank of San Francisco's website, at <http://www.frbsf.org/banking/letters>.

For additional information, please contact:

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<sup>5</sup> Creditors should review and consider regulatory underwriting guidelines, including the Interagency Guidance on Nontraditional Mortgage Product Risks, 71 FR 58609, Oct. 4, 2006, and the Statement on Subprime Mortgage Lending, 72 FR 37569, July 10, 2007.