DETAILED ANALYSIS OF CFPB'S FINAL ABILITY-TO-REPAY/QUALIFIED MORTGAGE RULE

JANUARY 23, 2013

After considering a proposed rule and comments for more than a year and a half, the Consumer Financial Protection Bureau (the "Bureau") has issued its highly anticipated final "Ability-to-Repay" rule (the "Rule") governing residential mortgage lending under Regulation Z.[1] As promised in our earlier flash Alert on the Rule, we are providing in this memorandum a detailed summary and analysis of the final Rule, which becomes effective on January 10, 2014. We also assess the Bureau's concurrently issued proposal (the "Concurrent Proposal"), which seeks comments by February 25, 2013 on potential amendments to the Rule.[2]

As noted in our earlier Alert, the Rule is likely to have a profound influence on the availability and cost of residential mortgage credit for many years, due to the severe penalties established by Congress for Rule violations. Specifically, a borrower in foreclosure may seek set-off damages from the creditor or assignee of the loan amounting to three years of finance charges and fees paid, as well as actual damages, prescribed statutory damages, court costs and attorney fees.[3] There is no statute of limitations on that foreclosure set-off action. A borrower also may file an affirmative suit within three years of an alleged violation.[4] TILA bars lenders from attempting, at the time of origination, to shift potential ability-to-repay (ATR) challenges into arbitration forums or nullifying the right to an ATR challenge through the use of a consumer waiver. The Bureau will examine bank and non-bank lenders for their compliance with the Rule, and may also bring enforcement actions for Rule violations. The Rule also is likely to become a subject of repurchase or indemnity requests, particularly given the existence of assignee liability; conversely, repurchase or indemnity requests from the government-sponsored enterprises (GSEs) or the Federal Housing Administration (FHA) could lead to allegations of violations of the Rule.

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1 Bureau of Consumer Financial Protection, Final Rule, Ability-to-Repay and Qualified Mortgage Standards under the Truth in Lending Act (Regulation Z)

(Jan. 10, 2013), http://files.consumerfinance.gov/f/201301_cfpb_final-rule_ability-to-repay.pdf (publication in the Federal Register forthcoming) [hereinafter "*Final Release*"].

2 Bureau of Consumer Financial Protection, Proposed Amendments to the Ability to Repay Standards under the Truth in Lending Act (Regulation Z) (Jan. 10, 2013), http://files.consumerfinance.gov/f/201301_cfpb_concurrent-proposal_ability-to-repay.pdf (publication in the Federal Register forthcoming) [hereinafter "*Concurrent Proposal Release*"].

3 Truth in Lending Act (TILA) § 130(a), (k).

4 TILA § 130(e).

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I. Scope and Overview

The Rule applies to all consumer-purpose, closed-end loans secured by a dwelling, including home-purchase loans, refinances and home equity loans — whether first- or subordinate-lien. The Rule does *not* cover:

- home equity lines of credit (HELOCs) or other open-end credit;
- mortgages secured by an interest in a timeshare plan;
- reverse mortgages;
- temporary or "bridge" loans 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;
- a construction phase of 12 months or less of a construction-to-permanent loan;
- business-purpose loans, even if secured by a dwelling;[5] or
- loan modifications, except in the rare case that a modification constitutes a "refinancing" under Regulation Z, 12 C.F.R. § 1026.20(a).[6]

The Rule provides that for loans within its scope, a creditor must "make[] a reasonable and good faith determination at or before consummation that the consumer will have a reasonable ability to repay the loan according to its terms."[7] That requirement may be satisfied in one of four ways:

- by following the Rule's general ability to repay standards in § 43(c),[8] which we will call the "General ATR Option";
- by making a qualified mortgage (a "QM") under § 43(e), which we will call the "QM Option";
- by refinancing a non-standard mortgage into a standard mortgage in compliance with § 43(d); and

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[5] 12 C.F.R. § 1026.43(a). This scope description applies only to the Rule's ability-to-repay requirements, *i.e.*, § 43(c)-(f). Section 43 also separately mandates, in § 43(g), limitations on prepayment penalties. The prepayment penalty limitations apply to reverse mortgages, temporary loans and construction loans, whereas the ATR Rule does not. § 43(a).

[6] *Final Release* at 407.

[7] § 43(c).

[8] Unless otherwise specified, this Alert hereafter uses shortened citations such as "§ 32" and "§ 43" to mean "12 C.F.R. § 1026.32" and "12 C.F.R. § 1026.43." Similarly, unless otherwise specified, the shortened citations "Cmt. 31" and "Cmt. 43" refer to the Comments to 12 C.F.R. § 1026.31 and § 1026.43, respectively. We also distinguish between "New § 31" — which refers to the provisions of § 31 that will become effective in January 2014 — and "Current § 31." Because there is no current version of § 43, we refer to it simply as "§ 43."

- for very small creditors that service primarily rural or underserved areas, by making a qualifying balloon mortgage in a rural or underserved area under § 43(f).

This memorandum focuses primarily on the General ATR Option and QM Option, because the other two ways of satisfying the Rule are applicable only in much more limited circumstances.

II. The General ATR Option

Under the General ATR Option, a creditor must (i) consider in its underwriting decision a number of specified financial items and (ii) verify by prescribed means the items it relies on in making a credit decision. Unlike the QM Option, there are no requirements relating to product features and no limitations on points and fees that may be charged.

A. Underwriting

1. General Principles

The list of underwriting and verification requirements for the General ATR Option is long but — in contrast to the underwriting and verification requirements to make a QM using the 43% debt-to-income (DTI) underwriting method (described below) — is not exhaustively detailed. Indeed, the General ATR Option provides the creditor with some degree of underwriting flexibility in making the ultimate determination of whether the consumer has the ability to repay the loan. As the Rule's commentary explains, the General ATR Option requirements

> do not provide comprehensive underwriting standards to which creditors must adhere. For example, the rule and commentary do not specify how much income is needed to support a particular level of debt or how credit history should be weighed against other factors. So long as creditors consider [eight specified underwriting factors — described immediately below] according to the requirements of [the Rule and verify items they rely on as prescribed], creditors are permitted to develop their own underwriting standards and make changes to those standards over time in response to empirical information and changing economic and other conditions.[9]

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[9] Cmt. 43(c)(1)-1.i; *see also* Cmt. 43(c)(2)-1 ("So long as a creditor [otherwise complies with the General ATR Option], the creditor is permitted to use its own definitions and other technical underwriting criteria."). *See also id.* (A creditor may, but need not, refer to GSE or federal agency "guidance to classify particular inflows, obligations, or property as 'income,' 'debt,' or 'assets.'" Likewise, "a creditor may refer to such guidance to determine what information to use when evaluating the income of a self-employed or seasonally employed consumer or what information to use when evaluating the credit history of a consumer who has obtained few or no extensions of traditional "credit.").

In sum, under the General ATR Option, the creditor does not have to follow the extensive underwriting guidance in Appendix Q (described below) that details how creditors seeking to meet the 43% DTI underwriting criteria for QM status must calculate income and other items.

2. The Eight Factors to Consider

In making the repayment ability determination under the General ATR Option, a creditor must consider the following eight underwriting factors (found at § 43(c)(2)(i)-(viii)):

i. Current or reasonably expected income or assets (other than the value of the collateral). The commentary makes clear that the creditor may consider assets alone, and "need consider only the income or assets necessary to support a determination that the consumer can repay the covered transaction." Thus, "if a consumer's loan application states that the consumer earns an annual salary from both a full-time job and a part-time job and the creditor reasonably determines that the consumer's income from the full-time job is sufficient to repay the loan, the creditor need not consider the consumer's income from the part-time job."[10]

   The Bureau provides further guidance on considering income and assets at Comment 43(c)(2)(i)-3, -4 and -5.

ii. If the creditor relies on income from the consumer's employment, then the consumer's current employment status.

iii. The monthly payment on the loan. For standard fixed and adjustable-rate mortgages (ARMs), the payments to be considered for underwriting purposes must be monthly, substantially equal and sufficient to fully amortize the loan over its term. Furthermore, payments on ARMs must reflect use of the "fully indexed rate" or any introductory rate (whichever is greater).[11]

   "Fully indexed rate" means the rate calculated using (a) the index or formula that would apply after "recast," as determined at the time of consummation, and (b) the maximum margin that can apply at any time during the loan term.[12] "Recast," in turn, means the expiration of the period during which (a) payments based on the introductory fixed interest rate are permitted, in the case of an ARM; (b) interest-only payments are permitted, in the case of an interest-only loan; and (c) during which negatively amortizing payments are permitted, in the case of a negative amortization loan.[13]

   The fully indexed rate must be determined without regard to any periodic interest rate adjustment cap that would limit a rate increase at recast. For

[10] Cmts. 43(c)(2)(i)-1, -2.

[11] § 43(c)(5)(i).

[12] § 43(b)(3).

[13] § 43(b)(11).

example, assume an ARM has an initial fixed rate of 5% for the first three years, after which the rate will adjust annually to a specified index plus a margin of 3%. The loan agreement provides for a 2% annual interest rate adjustment cap, and the index value in effect at consummation is 4.5 %. The fully indexed rate is 7.5% (4.5% plus 3%), despite the 2% annual interest rate adjustment cap that would make the actual interest rate at recast only 7%.[14]

Special rules apply to determining payments under balloon, interest-only and negative amortization loans.[15] The commentary provides detailed examples for arriving at the correct payment on all loan types.[16]

iv. The monthly payment on any "simultaneous loan" that the creditor "knows or has reason to know" will be made. "Simultaneous loan" means any loan covered by the Rule or any HELOC that will be secured by the same property as the loan at issue and that is made at, before or — if it will cover closing costs of the loan at issue — after consummation of the loan at issue.[17] To comply with the "knows or has reason to know" standard, the creditor is not obligated to investigate beyond what reasonable underwriting policies and procedures would call for in determining whether at or before consummation the same consumer has applied for another credit transaction secured by the same dwelling.[18]

If the simultaneous loan is itself subject to the Rule, then the creditor must determine the payments on it using the same principles that apply to determining monthly payments on the loan at issue. If it is a HELOC, the creditor must use "the periodic payment required under the terms of the plan and the amount of credit to be drawn at or before consummation" of the loan at issue.[19] The "amount of credit to be drawn" is "the amount requested by the consumer; when the amount requested will be disbursed, or actual receipt of funds, is not determinative."[20]

The creditor must also take into account "mortgage-related obligations" (see definition immediately below) on the simultaneous loan.[21]

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[14] Cmt. 43(b)(3)-3.

[15] *See* § 43(c)(5)(ii).

[16] Cmts. 43(c)(5)(i)-5, 43(c)(5)(ii).

[17] § 43(b)(12).

[18] Cmt. 43(c)(2)(iv)-2.

[19] § 43(c)(6).

[20] Cmt. 43(c)(6)-3.

[21] § 43(c)(6).

v. Monthly payment for "mortgage-related obligations". "Mortgage-related obligations" are property taxes, premiums on insurance required by the loan's creditor, condominium assessments and similar recurring charges.[22]

vi. Current debt obligations, alimony and child support. The commentary notes that "[c]reditors have significant flexibility to consider current debt obligations in light of attendant facts and circumstances, including that an obligation is likely to be paid off soon after consummation."[23]

vii. Monthly debt-to-income ratio (DTI) or residual income. "Residual income" is the amount of monthly income that would remain after subtracting the consumer's monthly debt obligations.[24] The DTI ratio and residual income are calculated straightforwardly using the income and expense items listed above.[25]

This provision of the General ATR Option, in contrast to the QM option under its 43% DTI underwriting method (discussed below), "does not prescribe a specific monthly DTI with which creditors must comply"; indeed, it does not require consideration of DTI (as opposed to residual income) at all. "Instead, an appropriate threshold for a consumer's monthly [DTI] ratio or monthly residual income is for the creditor to determine in making a reasonable and good faith determination of a consumer's ability to repay."[26] Presumably, a borrower who makes an ATR challenge under the Rule will allege that the creditor's determination was not reasonable or in good faith, so a lender defending such a challenge will want to be able to show that its determinations — potentially either the method used to calculate the monthly income or residual income or the standard against which that income was compared — were reasonable at the time they were made.

The commentary also notes that creditors may consider *compensating factors*, *i.e.*, "factors in addition to the monthly [DTI] ratio or residual income in assessing a consumer's repayment ability." "For example, the creditor may reasonably and in good faith determine that a consumer has the ability to repay despite a higher [DTI] ratio or lower residual income in light of the consumer's assets other than [the property to be secured], such as a savings account."[27]

viii. Credit history. This requirement to consider "credit history" does not mandate that creditors "obtain or consider a consolidated credit score." Moreover, in cases where a consumer has obtained few or no extensions of traditional credit, a

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22 § 43(b)(8).

23 Cmt. 43(c)(vi)-1.

24 Cmt. 43(c)(7)-2, -3.

25 § 43(c)(7).

26 Cmt. 43(c)(7)-1.

27 Cmt. 43(c)(7)-3.

creditor may "look to nontraditional credit references, such as rental payment history or utility payments."[28]

The requirement to consider credit history also "does not specify which aspects of credit history a creditor must consider or how various aspects of credit history should be weighed against each other or against other underwriting factors."[29] Instead, a creditor "may give various aspects of a consumer's credit history as much or as little weight as is appropriate to reach a reasonable, good faith determination of ability to repay."[30] As noted above on the monthly DTI ratio, presumably a borrower who makes an ATR challenge under the Rule will allege that the creditor's determination was not reasonable or in good faith, so a lender defending such a challenge will want to be able to show that its determination regarding credit history was a reasonable one at the time it was made.

B. Verification

A creditor must verify the information on which it bases its repayment ability determination by using reasonably reliable, written "third-party records" (except that employment status may be verified orally if the creditor makes a written record of the conversation).[31] "Third party record" primarily refers to "a document or other record prepared or reviewed by an appropriate person other than the consumer, the creditor, or the mortgage broker or an agent of the creditor or mortgage broker." The other "third party records" are:

- a copy of a tax return filed with the Internal Revenue Service or a State taxing authority;
- a record the creditor maintains for an account of the consumer held by the creditor; and
- where the consumer is an employee of the creditor or the mortgage broker, a document or other record maintained by the creditor or mortgage broker regarding the consumer's employment status or employment income.[32]

"Third party records" include records transmitted electronically.[33]

The Rule and especially the commentary provide substantial instruction on what types of records suffice for verifying specific items.[34] Below are some of the more important instructions:

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[28] Cmt. 43(c)(viii)-1.

[29] *Id.*

[30] *Id.*

[31] § 43(c)(3)-(4).

[32] § 43(b)(13).

[33] Cmt. 43(b)(13)-1.

[34] § 43(c)(3)-(4); Cmt. 43(c)(3)-(4).

- consistent with the analogous rule regarding what a creditor must *consider*, a creditor need only verify "the income or assets the creditor relies on to evaluate the consumer's repayment ability. For example, if a consumer's application states that the consumer earns a salary and is paid an annual bonus and the creditor relies on only the consumer's salary to evaluate the consumer's repayment ability, the creditor need verify only the salary;"[35]
- records "must be specific to the individual consumer. Records regarding average incomes in the consumer's geographic location or average wages paid by the consumer's employer, for example, are not specific to the individual consumer and are not sufficient for verification;"[36]
- a creditor may obtain records from a third-party service provider — such as a party the consumer's employer uses to respond to income verification requests — and directly from the consumer, as long as the records are reasonably reliable and specific to the individual consumer;[37]
- a creditor need not "obtain additional records to verify the existence or amount of obligations shown on a consumer's credit report or listed on the consumer's application," unless the creditor has reason to know the information may be suspect, inaccurate or subject to dispute;[38]
- thus, if the consumer's application states a current debt obligation not shown in the consumer's credit report, the creditor need not independently verify such an obligation, unless it has reason to know the information is suspect, inaccurate or subject to dispute;[39]
- conversely, if a credit report reflects a current debt obligation that a consumer has not listed on the application, the creditor may consider the existence and amount of the debt obligation as it is reflected in the credit report, again, unless it has reason to know the information is suspect, inaccurate or subject to dispute;[40] and
- the absence of an item from a credit report cannot serve to verify the item's non-existence.[41]

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[35] Cmt. 4(c)(4)-1.

[36] Cmt. 43(c)(3)-1.

[37] Cmt. 43(c)(3)-2.

[38] Cmts. 43(c)(3)-6; 43(c)(3)-3.

[39] § 43(c)(3)(iii).

[40] Cmt. 43(c)(3)-3.

[41] *Id.*

C. Guidance in the Commentary on Probative Evidence of Whether the Creditor Complied with the Rule

At Comment 43(c)(1)-1, the Bureau offers some guidance on items "that may be evidence that a creditor's ability-to-repay determination was" — or was not — "reasonable and in good faith":

- the longer a consumer successfully makes timely payments (without modification or accommodation) after consummation — or after recast in the case of an adjustable-rate, interest-only, or negative amortization mortgage — the less likely it is that the creditor's determination of the consumer's ability to repay was unreasonable or not in good faith;
- the use of "underwriting standards that have historically resulted in comparatively low rates of delinquency and default during adverse economic conditions" may be evidence of compliance with the Rule, whereas the use of standards that have "resulted in comparatively high levels of delinquency and default" may be evidence of non-compliance;
- the use of "underwriting standards based on empirically derived, demonstrably and statistically sound models" may be evidence of compliance, whereas the use of standards "inconsistently" or "different from those used for similar loans without reasonable justification" may be evidence of non-compliance;
- a "consumer's statement or attestation that the consumer has the ability to repay the loan is not indicative of whether the creditor's determination was reasonable and in good faith"; and
- evidence of non-compliance may include the creditor having disregarded that
  - the underwriting standards it used are not effective at determining consumers' repayment ability;
  - the consumer may have had insufficient residual income to cover other recurring obligations and expenses, taking into account the consumer's assets other than the collateral, after paying his or her monthly payments for the covered transaction, any simultaneous loans, mortgage-related obligations, and any current debt obligations; or
  - the consumer would have the ability to repay only if the consumer subsequently refinanced the loan or sold the collateral.

The commentary to the General ATR Option provisions also stress that the ultimate determination of whether the creditor's decision was reasonable and in good faith will be highly individualized and specific to the particular transaction at issue. Both the creditor's underwriting standards, the other considerations described and any other probative factor above "must be viewed in the context of all facts and circumstances relevant to a particular extension of credit," including how the underwriting standards "were applied to those facts and circumstances."[42]

[42] Cmts. 43(c)(1)-1.i; 43(c)(1)-1.ii.C.

III. Qualified Mortgages

A. Liability Protection

For loans that meet the QM definition, the Rule provides two degrees of protection against liability for violating it, depending on whether the QM is a "higher-priced covered transaction." "Higher-priced covered transaction" reflects a concept borrowed from the pre-existing, "higher-priced mortgage loan" regulation in § 35. Consistent with the definition there, it means a "covered transaction" (*i.e.*, a loan within the scope of the Rule) that carries an annual percentage rate (APR) exceeding the "average prime offer rate" (APOR) for a comparable transaction as of the date the interest rate is set by 1.5% or more for a first-lien loan, or by 3.5% or more for a subordinate-lien loan.[43] "APOR" and "comparable transaction" also are borrowed from the "higher-priced" regulation, and carry the same meanings as they do there.[44]

For QMs that are *not* higher-priced, the Rule provides a safe harbor; such a QM, without more, is deemed to "compl[y]" with the Rule.[45] The effect of this "safe harbor" is to create an additional line of defense for a creditor: the creditor may defend a claim under the Rule on the ground that it made a QM; if it did, then whether or not it made a reasonable or good faith determination of the borrower's repayment ability would be irrelevant. The value of this safe harbor, accordingly, will turn on how hard or easy it turns out to be to "hold" that line. The borrower, of course, would be free to attack the creditor's determination at many points. To name just a few, the borrower might attempt to show that the creditor failed to consider a debt of which it was aware at consummation and that, if considered, would have caused the QM underwriting criteria described below to have been violated; or, to preview another subject discussed below, he might attempt to show that a third-party fee otherwise not included in "points and fees" was unreasonable, thereby causing the relevant points and fees cap to be exceeded.

For QMs that *are* higher priced, the QM would be "presumed to comply" with the Rule.[46] "To rebut the presumption of compliance," the Rule states, "it must be proven that, despite having made a QM the creditor did not make a reasonable and good faith determination of the consumer's repayment ability."[47] To do so, the consumer must show that his

> income, debt obligations, alimony, child support, and the consumer's monthly payment (including mortgage-related obligations) on the covered transaction and on any simultaneous loans *of which the creditor was aware at consummation* would leave the consumer with *insufficient residual income or assets* other than the secured property *with which to meet living expenses*, including any recurring and

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43 § 43(b)(4).

44 Cmt. 43(b)(4)-1.

45 § 43(e)(1)(i).

46 § 43(e)(1)(ii)(A).

47 § 43(e)(1)(ii)(B).

> material non-debt obligations of which the creditor was aware at the time of consummation.[48]

In apparent contrast to the Rule's reference to what the creditor was "aware" of "at consummation" — language that implies actual knowledge, a higher standard than an objective test such as "should have been aware" — the commentary states that the borrower's proof may be "based on the information available to the creditor" (though the commentary elsewhere uses the "aware" formulation).[49] Whether a subjective standard (as the Rule uses) or a potentially more objective standard is adopted by the courts may become key to the presumption's effectiveness.

Commentary to the presumption provision also repeats the guidance for the General ATR Option that the longer the borrower demonstrates an actual ability to repay by making timely payments after consummation or (as the case may be) recast, "the less likely the consumer will be able to rebut the presumption."[50]

B. QM Requirements

To be a QM, a loan must satisfy three types of requirements: a product features test; one of two, alternative underwriting tests; and a points-and-fees limitation. We describe each requirement in turn below.

1. Product Features

All QMs must have a loan term not exceeding 30 years and provide for regular periodic payments that are substantially equal — except for the effect that an interest rate has in the case of an adjustable-rate or step-rate mortgage — that do not result in the increase of the principal balance (negative amortization), deferral of principal repayment, or a balloon payment.[51] The "loan term" for this purpose begins not on the date of consummation necessarily but on the often later date when the first full unit period of the repayment schedule begins.[52]

2. Underwriting

As noted above, a creditor intending to make a QM loan has the option of satisfying either of two underwriting tests: a "43% DTI" test, or a "GSE/Federal Agency" test.

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[48] *Id.* (emphasis added).

[49] Cmt. 43(e)(1)(ii)-1.

[50] *Id.*

[51] § 43(e)(2)(i)-(ii).

[52] Cmt. 43(e)(2)(ii).

a. The 43% DTI Alternative

The 43% DTI alternative prescribes underwriting guidelines that are structurally similar to those under the General ATR Option, but are much more detailed and specific. In particular, the 43% DTI alternative mandates that the creditor comply with Regulation Z's new Appendix Q, which contains over 35 pages of rules regarding what and how to consider income and liability items, as well as how such items must be verified. We do not attempt to summarize those rules here, but note that in general they require items to be considered and verified for the two prior years, and further require the gathering of information sufficient to make projections for the following three years.

In addition, we note that much of Appendix Q's language comes almost verbatim from the manual underwriting guidelines of the FHA's Single Family Handbook 4155.1, *Mortgage Credit Analysis for Mortgage Insurance*. One important difference from the FHA guidelines is that whereas they allow income not meeting their criteria to be considered as a compensating factor, Appendix Q altogether prohibits consideration of income not meeting that criteria. Note also that Appendix Q is based on the last published version of the FHA Handbook, dated March 24, 2011. It does not incorporate subsequent changes made by the FHA through mortgagee letters.

Using Appendix Q, the creditor must consider the following underwriting factors, which we have arranged so as to facilitate comparison with the factors under the General ATR Option:

i. Current or reasonably expected income or assets (other than the value of the collateral).[53] The "creditor *must* consider and verify, at a minimum, any income specified in appendix Q." While the "creditor *may also* consider and verify any *other income* in accordance with" the provisions of the General ATR Option, such other income cannot "be included in the total monthly [DTI] determination" that must equal 43% or less, as described below.[54]

ii. If the creditor relies on income from the consumer's employment, then the consumer's current employment status. This must be done in accordance with Appendix Q.

iii. The monthly payment on the loan. The monthly payment that must be considered is calculated in a manner similar but not identical to the calculation prescribed under the General ATR Option. Here, the creditor must use the "maximum interest rate" that may apply in the first five years after the date on which the first regular periodic payment will be due.[55] Unlike the interest rate calculation applicable in the General ATR Option, which relies on the "fully indexed rate" concept, the "maximum in the first five years" concept permits the

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53 *See* § 43(e)(2)(v)(A).

54 Cmt. 43(e)(2)(v)-2 (emphasis added).

55 § 43(e)(2)(iv).

creditor to apply any periodic interest rate adjustment caps that may limit how quickly the interest rate can increase.[56]

The creditor must then apply the "maximum interest rate," as so determined, to calculate periodic payments of principal and interest that will repay either

- the outstanding principal balance over the remaining term of the loan as of the date the interest rate adjusts to that maximum rate, assuming the consumer will have made all required payments as due prior to that date; or
- the loan amount over the loan term.[57]

The former will require more effort to calculate, but should result in a lower payment for underwriting purposes because the borrower will have been able to pay down more of the loan during the period before the interest rate reaches its maximum level. The commentary provides detailed examples of how to calculate these payments for all types of loans.[58]

iv. The monthly payment on any "simultaneous loan" that the creditor "knows or has reason to know" will be made. The standards for considering any "simultaneous loan" — and its "mortgage-related obligations" — are no different from those applicable under the General ATR Option.[59]

v. Monthly payment for "mortgage-related obligations". The meaning of "mortgage-related obligations" is no different from that applicable to the General ATR Option.[60]

vi. Current debt obligations, alimony and child support.[61] The "creditor *must* consider and verify, at a minimum, any debt or liability specified in Appendix Q." While the "creditor *may also* consider and verify any *other debt* in accordance with" the provisions of the General ATR Option, such other debt cannot "be included in the total monthly [DTI] determination" that must equal 43% or less, as described below.[62]

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[56] Cmt. 43(e)(2)(iv)-3.

[57] § 43(e)(2)(iv).

[58] *See* Cmt. 43(e)(iv)-3, -4, -5, and -7.

[59] *See* 43(e)(vi)(B)(2).

[60] *See* §§ 43(e)(2)(iv), 43(e)(vi)(B)(1).

[61] *See* § 43(e)(2)(v)(B).

[62] Cmt. 43(e)(2)(v)-3 (emphasis added).

vii. Monthly debt-to-income ratio ("DTI") or residual income. This provision of the QM option, in contrast to the General ATR Option, prescribes a specific monthly DTI with which creditors must comply: 43% or below.[63]

Credit history is the one underwriting factor that must be considered under the General ATR Option but not under this 43% DTI alternative for QM loans.

b. The GSE / Federal Agency Alternative

Under the "GSE / Federal Agency" underwriting alternative, a loan passes the QM underwriting test if at consummation it is eligible:

- to be purchased or guaranteed by Fannie Mae or Freddie Mac (or any limited-life regulatory entity succeeding the charter of either) operating under the conservatorship or receivership of the Federal Housing Finance Agency (FHFA);
- to be insured by the U.S. Department of Housing and Urban Development (HUD) under the National Housing Act;
- to be guaranteed by the U.S. Department of Veterans Affairs (VA);
- to be guaranteed by the U.S. Department of Agriculture pursuant to its Single Family Housing Guaranteed Loan Program; or
- to be insured by the Rural Housing Service (RHS).[64]

To pass this underwriting test, a loan need not actually be purchased or guaranteed by a GSE or insured or guaranteed by one of the federal agencies; rather, the Rule "requires only that the loan be eligible (*i.e.*, meet the criteria) for such purchase, guarantee, or insurance."[65]

To determine eligibility, a creditor may rely on an underwriting recommendation provided by a GSE Automated Underwriting System (AUS) or written guide in effect at the time. Thus, as to the GSE AUS's, a loan is "eligible" under the Rule if it receives an "Approve/Eligible" recommendation from Fannie Mae's Desktop Underwriter system or an "Accept and Eligible to Purchase" recommendation from Freddie Mac's Loan Prospector system.[66] Neither the Rule nor the commentary explicitly confirms that a creditor may also rely on a positive recommendation from the FHA's AUS, or from a private lender or insurer AUS that has been approved by the GSEs as generating equivalent outcomes.

The availability of this underwriting alternative is time limited. The option of using eligibility for purchase or guarantee by a GSE will not be available if that GSE (or any limited-life regulatory entity succeeding it) has ceased operating under the conservatorship or

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[63] § 43(e)(2)(vi).

[64] § 43(e)(4).

[65] Cmt. 43(e)(4)-4.

[66] *Id*

receivership of FHFA.[67] The option of using eligibility under a federal agency's program will expire on the effective date of any rule issued by the agency pursuant to its authority under the Dodd-Frank Wall Street Reform and Consumer Protection Act to define a QM that it will insure or guarantee. And, under a sunset provision, the entire GSE / Federal Agency alternative will not be available for loans originated after January 10, 2021, *i.e.*, seven years after the Rule's effective date.[68]

3. Points and Fees

a. General Rules and Sliding Scale

The Rule provides that to be a QM under either the 43% DTI or the GSE / Federal Agency underwriting alternative, the "points and fees payable in connection with the loan" cannot exceed specified amounts or percentages of the "total loan amount."[69] Those caps depend on what the "loan amount" is.[70] For loan amounts greater than or equal to $100,000, the cap on points and fees is 3% of the total loan amount. For loan amounts below $100,000, the caps are:

- $60,000 - $99,999: $3,000
- $20,000 - $59,999: 5% of the total loan amount
- $12,500 - $19,999: $1,000 cap; and
- $12,499 and below: 8% of the total loan amount.

All dollar amounts associated with the points and fees limitation — *i.e.*, loan amount, total loan amount, and dollar caps — will be indexed for inflation.[71]

With only minor exceptions, the definition of "points and fees" for QM purposes tracks the new definition of the term for purposes of the Home Ownership and Equity Protection Act ("HOEPA").[72] This Alert focuses only on the meaning of "points and fees" for purposes of the QM regulations.

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[67] Cmt. 43(e)(4)-2.

[68] § 43(e)(4)(iii).

[69] §§ 43(e)(2)(iii), (e)(3), (e)(4)(i)(A). Total loan amount "is calculated by taking the amount financed, as determined according to § 1026.18(b), and deducting any cost" that is added to "points and fees" by New § 32(b)(1)(iii), (iv), or (vi) and "financed by the creditor." § 32(b)(4). The commentary contains several examples of how to calculate the "total loan amount." *See* New Cmt. 32(b)(4)(i)-1.

[70] The "loan amount" is simply the principal amount as reflected on the promissory note or loan contract. § 43(b)(5).

[71] § 43(e)(3)(i). The amounts will be "adjusted annually on January 1 by the annual percentage change in the Consumer Price Index for All Urban Consumers (CPI-U) that was reported on the preceding June 1." § 43(e)(3)(ii).

[72] § 43(b)(9); New § 32(b)(1).

The points and fees definition presents a threshold issue of timing. Specifically, the opening clauses of the definition provide that "*points and fees* means the following fees or charges *that are known at or before consummation*."[73] The commentary explains that in general, a charge is "known" in this sense if "the creditor *knows at or before consummation that the charge or fee will be imposed in connection with the transaction, even if the charge or fee is scheduled to be paid after consummation*."[74] Thus, a charge to the customer that is known by consummation is includable in "points and fees" "even if the consumer finances it and repays it over the loan term."[75] As this Alert explains below, however, this general guidance in the commentary is at times over-ridden by specific directions in the Rule about whether particular charges are in or out of the definition.

b. Non-Interest Components of the Finance Charge

(1) The General Rule

Subject to the five important exceptions described below, "points and fees" includes all non-interest components of the finance charge.

(2) Exceptions to Including Non-Interest Components of the Finance Charge

i. Government Mortgage Insurance or Guarantee Fees

"Points and fees" does not include government mortgage insurance or guarantee fees, *i.e.*, FHA mortgage insurance premiums or guarantee fees for VA or RHS loans. This rule applies whether the fees are payable before, at, or after consummation. Thus, both up-front fees and post-consummation periodic payments are excluded.[76]

ii. All PMI Fees Payable After Closing

"Points and fees" also does not include private mortgage insurance ("PMI") premiums or other charges that are "payable after consummation."[77] This is so "even if the amounts of such premiums and charges are known at or before consummation."[78]

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[73] New § 32(b)(1) (second emphasis added).

[74] New Cmt. 32(b)(1)-1.i (emphasis added).

[75] New Cmt. 32(b)(1)-1.i.

[76] § 32(b)(1)(i)(B).

[77] § 32(b)(1)(i)(C)(1).

[78] New Cmt. 32(b)(1)-1.iii.

iii. At Least a Portion of Certain Up-front PMI Fees

At least a portion of PMI premiums or charges "payable at or before consummation" — so-called "up-front" premiums — are excluded from "points and fees" where the premium is refundable on a pro rata basis and the refund is automatically issued upon notification that the loan is paid in full.[79] If that "refundability" condition is satisfied, then a creditor may exclude from "points and fees" the portion of the up-front premium that does not exceed the amount that the borrower would pay for FHA insurance on the transaction. A creditor should make the comparison to the FHA amount "even if the transaction would not qualify to be insured [by the FHA] (including, for example, because the principal amount exceeds the maximum insurable under [FHA policies])."[80] Any portion of the up-front PMI premium that is above the FHA amount will be included in "points and fees," whether it satisfies the refundability condition or not. The commentary provides a numerical example to explain this rule on up-front PMI premiums.[81]

The commentary emphasizes that this provision refers to PMI premiums that are "payable" at or before consummation, regardless of whether they are actually paid in cash at that time or financed.[82]

iv. Unretained Third Party Charges Not Expressly Included as Points and Fees by Other Provisions of the Rule

The Rule excludes from "points and fees" "[a]ny bona fide third-party charge not retained by the creditor, loan originator, or an affiliate of either," but then carves out exceptions to the exclusion that limit its practical impact.[83] Specifically, the following charges are exceptions to this exclusion, *i.e.*, the following count as "points and fees" regardless of whether or not they are "retained by the creditor, loan originator, or an affiliate of either":

- as discussed above, PMI premiums "payable at or before consummation" that either exceed the FHA premium level or are not required to be automatically refunded on a pro-rata basis when the loan is paid in full;
- real estate charges that are not "reasonable," as discussed below in connection with New § 32(b)(1)(iii); and
- premiums for credit insurance and debt cancellation or suspension coverage that are "payable at or before consummation," as discussed below in connection with New § 32(b)(1)(iv).

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[79] New § 32(b)(1)(i)(C)(2).

[80] New Cmt. 32(b)(1)(C)-1.ii(A).

[81] New Cmt. 32(b)(1)(C)-1.ii(C).

[82] New Cmt. 32(b)(1)(C)-2.

[83] New § 32(b)(1)(i)(D).

An "affiliate" is "any company that controls, is controlled by, or is under common control with another company, as set forth in the Bank Holding Company Act of 1956."[84] Under this Act, one company "controls" another if it (a) directly or indirectly owns 25% or more of any class of voting securities of the other company, (b) controls in any way the election of a majority of the other company's directors, or (c) "exercises a controlling influence over the [other company's] management or policies."[85] The concepts of "control" and "controlling influence" are broadly defined; the Federal Reserve's determination of whether a company exercises a controlling influence over another is based on a fact-specific analysis of the contours of the business relationship, such as the company's total equity ownership and board representation. As a result, a creditor that has a business relationship with a settlement service provider, such as an appraisal company or title insurance agency, may be deemed to be an affiliate of that provider – regardless of whether the creditor controls the service provider from an operational perspective or whether it retains any of the charges for services provided.

One item discussed extensively in the *Final Release* that the Bureau concluded is also not excluded from "points and fees" under this provision is a point charged to the consumer to offset loan-level price adjustments ("LLPAs") imposed by the GSEs. GSEs make LLPAs — effectively discounts on what they are willing to pay for a loan — to compensate for added credit risks, such as a low credit score. Some creditors have offset lost revenue resulting from LLPAs by transferring the cost to consumers in the form of points.[86] The Bureau reasoned that the "manner in which creditors respond to LLPAs is better viewed as a fundamental component of how the pricing of a mortgage loan is determined rather than as a third-party charge."[87] Thus, the Bureau explained that such points may be excluded from "points and fees," if at all, only via the "bona fide discount points" exclusion, discussed in the next section below.[88]

What is left of this exclusion for "bona fide third-party charge[s] not retained by the creditor, loan originator, or an affiliate of either" seems to be largely duplicative of other exclusions, particularly the exclusion for many types of (reasonable) real estate related fees paid to third party non-affiliates in § 32(b)(1)(iii), discussed below, and pre-existing exclusions from the finance charge, such as the exclusion of property insurance premiums where the consumer chooses the insurer.[89] (The commentary to the new Rule makes clear that except as otherwise

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[84] § 32(b)(5).

[85] 12 U.S.C. § 1841(a)(2).

[86] *Final Release* at 75.

[87] *Id.* at 80.

[88] *Id.* at 80. Implicit throughout the Bureau's discussion of LLPAs is that if a creditor chooses to recover its cost by increasing the interest rate charged to the consumer, the increase in the interest rate would *not* add to "points and fees." *Id.* at 75-77, 80. This is consistent with the general exclusion from "points and fees" of the interest component of the finance charge, notwithstanding the Bureau's guidance in the commentary that the Rule's use of the phrase "charges that are known at or before consummation" in § 32(b)(1) refers to charges that "the creditor knows at or before consummation … will be imposed in connection with the transaction, even if the charge or fee is scheduled to be paid after consummation." Cmt. 32(b)(1)-1.i.

[89] § 4(d)(2).

specified by it, items excluded from the finance charge in § 4 are excluded from "points and fees."[90])

v. Certain "Bona Fide Discount Points" on Lower Interest Loans

The final exception to the general principle that non-interest finance charges are "points and fees" concerns "bona fide discount points." A "bona fide discount point" is "an amount equal to 1 percent of the loan amount paid by the consumer that reduces the interest rate … based on a calculation that is consistent with established industry practices."[91] The commentary provides detailed guidance on how a creditor can show that its calculation satisfies this "bona fide" standard.[92]

The Rule excludes varying amounts of "bona fide discount points" depending on how close the undiscounted interest rate is on the date the rate is set to the "APOR", a term borrowed from the Bureau's "higher-priced mortgage loan" regulation at § 35.[93] Effectively, this provision discourages creditors from offering less creditworthy borrowers the option of paying discount points.

This exclusion specifically allows creditors to exclude:

- up to two bona fide discount points if the pre-discounted interest rate does not exceed the APOR by more than one percentage point; and
- up to one bona fide discount point if the pre-discounted rate does not exceed the APOR by more than two percentage points.

The commentary provides useful numerical examples of how this exclusion applies in practice.[94]

c. Loan Originator Compensation

New § 32(b)(1)(ii) includes in the calculation of points and fees "[a]ll compensation paid directly or indirectly by a consumer or creditor to a loan originator … that can be attributed to that transaction at the time the interest rate is set." This one sentence raises many issues, which are addressed in both the Rule and the Concurrent Proposal.

First, vocabulary:

- "Compensation" includes the dollar value of monetary and non-monetary rewards, such as "a bonus, commission, or award of merchandise, services, trips, or similar

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[90] *See* New Cmt. 32(b)(1)(i)-1.

[91] § 32(b)(3)(i).

[92] New Cmt. § 32(b)(3)-1.

[93] New Cmt. 32(b)(1)(i)(E)-2.

[94] *See* New Cmts. 32(b)(1)(i)(E)-3 and 32(b)(1)(i)(F)-2.

prizes." It is not dependent on what it is called, but rather includes whatever the loan originator retains.[95]

- "Loan originator" is defined by cross reference to the loan originator compensation rules. Under those rules, "loan originator" means a person who for — or in expectation of — compensation, arranges, negotiates, or otherwise obtains a loan for another person.[96] Because the word "person" in this definition includes both individuals and organizations, "loan originator" can include a mortgage brokerage, employees hired by either a brokerage or a creditor, and independent individual mortgage brokers. But it excludes a creditor that provides the funds for the transaction.[97] We use "creditor" below in that sense.

Issues raised by this provision can be grouped into four categories, which we discuss in turn below: (a) What compensation can be "attributed to [the] transaction" at issue?; (b) When is the amount of attributable compensation determined?; (c) How to address the issue of double-counting that arises within the four corners of this provision, New § 32(b)(1)(ii)?; and (d) How to address double-counting issues that arise from the interaction of this provision and New § 32(b)(1)(i), which as discussed above includes in "points and fees" non-interest finance charges with exceptions?

(1) Attributing Compensation to a Particular Transaction

The Rule counts as "points and fees" only amounts "that can be attributed to [the] transaction." The commentary explains that this means the amount the loan originator will receive if the particular transaction is consummated. It excludes compensation that cannot be attributed to the transaction at issue, such as:

- compensation based on the long term performance of the loan originator's loans;
- compensation based on the overall quality of a loan originator's loan files; and
- the base salary of a loan originator.[98]

The commentary provides several examples applying this attribution concept at New Cmt. 32(b)(1)(ii)-4.

(2) When is the Amount of Attributable Compensation Determined?

As the Rule provides, the amount of compensation is calculated "at the time the interest rate is set."[99] Subsequent events that might change what the loan originator is ultimately entitled

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95 New Cmt. 32(b)(1)(ii)-1, -2.

96 § 36(a)(1).

97 Cmt. 36(a).

98 New Cmt. 32(b)(1)(ii)-2.

99 New § 32(b)(1)(ii).

to on the transaction — such as, for example, an increase in the per transaction commission resulting from the loan originator originating enough additional loans to surpass a volume target — have no effect on the calculation. The time when the compensation is actually paid to the loan originator also is not relevant.[100] New Cmt. 32(b)(1)(ii)-3 provides a numerical example of this timing rule.

(3) Double-Counting Issues Within the Four Corners of New § 32(b)(1)(ii)

The inclusion in "points and fees" of loan originator compensation "paid *directly or indirectly* by a consumer or creditor to a *loan originator*" creates a major double-counting issue for the mortgage broker industry because both a mortgage brokerage and an employee of it that worked on the transaction are "loan originators."[101] For example, assume a consumer or creditor pays $1,000 to a mortgage brokerage, which passes along $500 of that amount to its employee.[102] Because both the brokerage and the employee are "loan originators," each of the two payments would be included in "points and fees": the first as a *"direct[]"* payment from a "consumer or creditor to a loan originator," and the second as an *"indirect[]"* payment from a "consumer or creditor to a loan originator." Thus, even though the two "loan originators" keep only a total of $1,000 between them, the amount included in "points and fees" would be $1,500.

Fortunately, the Bureau in the Concurrent Proposal has included a comment that would reverse that result if the Bureau adopts the proposed comment as currently written. Specifically, the comment would provide that "[c]ompensation paid by a mortgage broker to its individual loan originator employee is not included in points and fees." Thus, in the example above, the $1,000 "*direct[]*" payment would be included in "points and fees," but the $500 "*indirect[]*" payment would not be.[103]

(4) Double-Counting Issues Between New § 32(b)(1)(i) and (ii)

Double-counting issues between these two provisions arise because fees paid by a consumer to either a mortgage brokerage or a creditor are non-interest finance charges that are

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[100] New Cmt. 32(b)(1)(ii)-3.

[101] New § 32(b)(1)(ii) (emphasis added).

[102] Regulation Z currently provides that where a loan originator receives compensation directly from a consumer in connection with a mortgage loan, no loan originator may receive compensation from another person in connection with the same transaction. § 36(d)(2). Under the "Loan Originator Compensation Requirements under the Truth in Lending Act (Regulation Z)" Final Rule, released by the Bureau on January 20, 2013, however, a mortgage brokerage may, from a consumer payment to it, pay its loan originator employees commissions, provided that the commissions cannot be based on the terms of the loans that they originate. New §36(d)(2)(i)(C). *See* http://files.consumerfinance.gov/f/201301_cfpb_final-rule_loan-originator-compensation.pdf (publication in the Federal Register forthcoming).

[103] Proposed Cmt. 32(b)(1)(ii)-5.ii.

included in "points and fees" by New § 32(b)(1)(i). The issues presented by the consumer's payments to the two entities are different, however.

In the former case, because a mortgage brokerage is a "loan originator," *the very same fee* from the consumer to the mortgage brokerage would be both a non-interest finance charge under Paragraph (i) of New § 32(b)(1) and "compensation paid directly … by a consumer … to a loan originator" under Paragraph (ii). The same fee would therefore be counted twice under the Rule as the Bureau finalized it. Fortunately once again, however, the Bureau in its Concurrent Proposal has included a comment that would reverse this result if the Bureau adopts the proposed comment as currently written. Specifically, the comment would provide that "[m]ortgage broker fees already included in the points and fees calculation under § 1026.32(b)(1)(i) [*i.e.*, payments by consumers to mortgage brokers] — need not be counted again under § 1026.32(b)(1)(ii)."[104]

The latter case, where the consumer pays a fee to the creditor, presents a different double-counting issue. Here, there is no problem of double counting *the very same fee*, because a creditor (as we are using the term here) is not a loan originator; accordingly, the payment is included in "points and fees" only in Paragraph (i) of New § 32(b)(1) and not under Paragraph (ii). Instead, the problem arises where the creditor passes along part or all of the fee to an employee or to a mortgage brokerage, both of which *are* loan originators. That second payment, under the Rule as finalized, is "compensation paid directly by a … creditor to a loan originator" (as well as "compensation paid … indirectly by a consumer … to a loan originator," for that matter). Thus, if the consumer paid the creditor a $3,000 fee and the creditor passed along $1,500 of that amount to an employee or to a mortgage brokerage, $4,500 would be included in "points and fees".

In the Concurrent Proposal, the Bureau is proposing comment on two alternatives to address this result. Alternative 1 would confirm it, largely on the ground that — in the Bureau's view — the result accords with congressional intent.[105] Alternative 2 would reverse the result by providing that a creditor must "reduce the amount of loan originator compensation included in the points and fees calculation under § 1026.32(b)(1)(ii) by any amount included in the points and fees calculation under § 1026.32(b)(1)(i)." In the example above, therefore, the $3,000 fee included under Paragraph (i) would reduce to $0 the $1,500 payment to the creditor's employee or mortgage brokerage otherwise includable under Paragraph (ii), leaving $3,000 as the amount to be included in "points and fees." And, if the consumer's payment to the creditor were only $1,000 and the creditor in turn paid its employee or mortgage brokerage a higher amount, $1,500, the $1,000 included in Paragraph (i) would reduce the $1,500 otherwise includable under Paragraph (ii) to $500, leaving the amount to be included in "points and fees" equal to $1,000 from Paragraph (i) plus $500 from Paragraph (ii), or $1,500 in total.[106]

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[104] Proposed Cmt. 32(b)(1)(ii)-5.i. Presumably, the Bureau is using "mortgage broker" as it is defined in the loan originator compensation regulation, § 36; that definition refers to both a mortgage brokerage and an independent individual broker.

[105] *See Concurrent Proposal Release* at 60, 62-63.

[106] Proposed Cmt. 32(b)(1)(ii)-5.iii (Alternative 2).

d. Charges for Certain Real Estate Related Services

Also included in "points and fees" are certain charges for real estate related services. We will describe what we mean by "real estate related services" below, but first wish to note the circumstances under which they are included in "points and fees." Specifically, they will be included where:

- the charge is paid to an affiliate of the creditor;
- the creditor receives direct or indirect compensation in connection with the charge; or
- the charge is unreasonable.[107]

The inclusion of charges paid to an affiliate of the creditor will place severe stress on the many lenders who, for reasons of convenience and otherwise, affiliate with settlement service providers.

The charges for the "real estate related services" at issue are all "items listed in § 1026.4(c)(7) (other than amounts held for future payment of taxes)."[108] Section 4(c)(7) lists the following:

- fees for title examination, abstract of title, title insurance, property survey, and similar purposes;
- fees for preparing loan-related documents, such as deeds, mortgages, and reconveyance or settlement documents;
- notary and credit-report fees;
- property appraisal fees or fees for inspections to assess the value or condition of the property if the service is performed prior to closing, including fees related to pest-infestation or flood-hazard determinations; and
- amounts required to be paid into escrow or trustee accounts if the amounts would not otherwise be included in the finance charge.

e. Premiums for Credit Insurance and Debt Cancellation or Suspension Coverage "Payable at or Before Consummation"

"Points and fees" also includes the following three related types of charges, but only where they are "payable at or before consummation":

- any credit life, credit disability, credit unemployment, or credit property insurance[109]

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[107] New § 32(b)(1)(iii).

[108] New § 32(b)(1)(iii).

[109] "Credit property insurance," the commentary explains, is "insurance against loss of or damage to personal property, such as a houseboat or manufactured home;" it "covers the creditor's security interest in the property;" and does "not include homeowners' insurance, which, unlike credit property insurance,

- any other life, accident, health, or loss-of-income insurance for which the creditor is a beneficiary, and
- any payments directly or indirectly for any debt cancellation or suspension agreement or contract.[110]

The commentary clarifies that so long as these charges are "payable at or before consummation," it does not matter whether they are paid in cash or, if permitted by applicable law, financed." The commentary also states that whether the credit insurance or debt cancellation coverage is "optional or required" is immaterial to the determination of whether the charges are included as points and fees.[111]

f. Prepayment Penalties

Certain prepayment penalties also are counted toward the 3% cap. Specifically, both of the following are included in "points and fees":

- the maximum "prepayment penalty"[112] that may be charged or collected under the terms of the mortgage loan; and
- the total "prepayment penalty" that would be incurred by the consumer if the consumer were to refinance the existing mortgage loan with any of the following: (a) the current holder of the existing loan, (b) a servicer acting on behalf of the current holder, or (c) an affiliate of either.[113]

As the Bureau acknowledges, the inclusion of these contingent charges in "points and fees" represents an exception to the general rule that the "known at or before consummation" limitation on points and fees means that the creditor must know "that the charge or fee will be imposed."[114] The creditor obviously does not know whether a prepayment penalty will be imposed, but the amount of such a contingent charge is nonetheless part of "points and fees."

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typically covers not only the dwelling but its contents and protects the consumer's interest in the property." New Cmt. 32(b)(1)(iv)-2.

[110] New § 32(b)(1)(iv).

[111] New Cmt. 32(b)(1)(iv)-1.

[112] A "prepayment penalty" under the Rule generally will include — in addition to more obvious examples — an origination or other closing cost fee that is waived by the creditor on the condition that the consumer does not prepay the loan. New Cmt. 32(b)(6)-1.ii. However, such a waived charge will not be considered a "prepayment penalty" to the extent it is bona fide if (i) it is a third-party charge and (ii) the waiver applies only to prepayments of "all of the transaction's principal sooner than 36 months after consummation." New § 32(b)(6).

"Prepayment penalties" also do not include fees imposed for preparing and providing documents when a loan is paid in full — such as a payoff statement or a reconveyance document – so long as such fees are imposed whether or not the loan is prepaid. New Cmt. 32(b)(6)-2.i.

[113] Section 32(b)(1)(v) and (vi).

[114] Cmt. 32(b)(1)-1.i, ii.

IV. Other Matters Addressed by the Rule

A. Refinance of a Non-Standard Mortgage into a Standard Mortgage

The Rule provides creditors with an exemption from the General ATR Option when a customer's "non-standard mortgage" is refinanced to a "standard mortgage."[115] A "non-standard mortgage" is defined as (1) an ARM with an introductory fixed rate for a period of 1 year or longer, (2) an interest-only loan or (3) a negative amortization loan.[116] A balloon-payment loan is not a non-standard mortgage.[117]

A "standard mortgage" must provide for regular payments and cannot have negative amortization, interest-only or balloon-payment features.[118] A standard mortgage must also satisfy the following criteria:

- the interest rate is fixed for at least the first 5 years after consummation;
- the total points and fees payable in connection with the loan complies with the 3% (or otherwise applicable) cap for qualified mortgages;
- the loan term does not exceed 40 years; and
- the proceeds of the loan will only be used to pay the outstanding balance of the non-standard mortgage and closing and settlement fees for the standard mortgage.[119]

A creditor must consider whether the consumer is likely to default on the existing non-standard mortgage when the loan is recast and whether a standard mortgage would likely prevent the consumer's default. Provided that the creditor has made these preliminary determinations, refinances from a non-standard mortgage to a standard mortgage will be exempt from the ability to repay requirements if: (1) the creditor for the standard mortgage is the current holder of the existing non-standard mortgage; (2) the monthly payment for the standard mortgage is "materially lower" than the payment on the non-standard mortgage; (3) the creditor receives the consumer's written application for the standard mortgage no later than two months after the non-standard mortgage has recast; and (4) the consumer has made no more than one payment 30 days late on the non-standard mortgage in the 12 months preceding the application, and no such late payments in the preceding 6 months.

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115 § 43(d).

116 § 43(d)(1)(i).

117 *Final Release* at 300. The Bureau explained that balloon payment loans "pose a different kind of risk to consumers, one that arises not from the monthly payments (which often tend to be low) but from the balloon payment due when the entire remaining balance becomes due." *Id.*

118 § 43(d)(1)(ii).

119 *Id.*

B. QM Status for Balloon Loans Made by Small Creditors in Rural or Underserved Areas

The Rule provides QM status to certain balloon-payment loans originated by small creditors that operate in predominantly rural or underserved areas, as designated by the Bureau.[120] "Small creditors" here means those that have less than $2 billion in assets and (together with their affiliates) originate no more than 500 first-lien loans within the scope of the Rule per year.

A balloon payment QM must satisfy the QM product features requirements except for the prohibitions on balloon payments and deferment of principal. Thus, a balloon payment QM still cannot result in negative amortization, have a loan term that exceeds 30 years, or have "points and fees" that exceed the 3% (or other applicable) cap.[121] Further, balloon payment QMs must satisfy the following criteria:

- the creditor must determine at or before closing that the consumer can pay the monthly mortgage payments and mortgage-related obligations (excluding the balloon payment) from the consumer's current or reasonably expected income or assets;
- the creditor must consider and verify the consumer's DTI ratio or residual income in support of its repayment ability determination;
- the scheduled payments on the loan must be substantially equal and calculated using an amortization schedule that does not exceed 30 years;
- the interest rate must not increase; and
- the loan must have a term of 5 years or more.[122]

Generally, a creditor must hold a balloon-payment QM in its portfolio in order for the loan to maintain QM status. But the Rule carves out certain instances where a balloon payment could be sold, assigned or transferred to another person without losing the loan's QM status.[123]

C. Prepayment Penalties

Section 43(g) implements statutory limitations on when prepayment penalties may be charged.[124] Prepayment penalties of any kind are prohibited unless the loan is a QM, the APR cannot increase after consummation, and the APR is not more than 1.5% over the APOR at the time the interest rate is set on a comparable transaction."[125]

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[120] § 43(f).

[121] New Cmt. § 43(f)(1)(i)-1.

[122] § 43(f)(1)(i)-(vi).

[123] § 43(f)(2).

[124] As noted above, this provision limiting prepayment penalties applies to reverse mortgages, bridge loans with terms of 12 months or less and the construction phase of 12 months or less of a construction-to-permanent loan, whereas the ability-to-pay regulations do not.

[125] § 43(g)(1).

Where prepayment penalties are allowed, there are limitations on the amount and duration of the penalty. Section 43(g)(2) contains the following limitations:

- a prepayment penalty cannot apply after the first 3 years following consummation;
- if the prepayment penalty is incurred during the first 2 years following consummation, the amount of the penalty cannot exceed 2% of the outstanding loan balance that is prepaid; and
- if the prepayment penalty is incurred during the third year following consummation, the amount of the penalty cannot exceed 1% of the outstanding loan balance that is prepaid.

A creditor that offers a loan with a prepayment penalty is required to provide a consumer with an alternative loan option (an "Alternative Loan") that, among other requirements, does not contain a prepayment penalty and has an APR "that cannot increase after consummation."[126] Creditors that offer loans with prepayment penalties through a mortgage broker must present the broker with an Alternative Loan and enter into an agreement that would require the broker to provide the consumer with either (i) an Alternative Loan by the creditor or (ii) an Alternative Loan by a second creditor, if the Alternative Loan offered by the second creditor has a lower interest rate or lower total dollar amount of origination points and fees.[127]

D. Record-Keeping

The Rule requires creditors to retain records that show compliance with it for three years after consummation, to align a creditor's record-keeping obligation with the Rule's three-year statute of limitations on a borrower's affirmative suit for an alleged violation.[128] A creditor's existing obligation to retain evidence of compliance with Regulation Z generally for two years after disclosures must be made or action must be taken remains unchanged.[129]

While the Bureau mandates a three-year retention period with respect to the Rule, it believes that "responsible creditors will likely elect to retain records of compliance with" § 43 "well beyond three years," due to the absence of any statute of limitations on a borrower's ability to seek recoupment or set-off in foreclosure for a § 43 violation. [130]

The record retention period starts "after consummation of a transaction covered by" the Rule.[131] Even though a creditor will begin to create a consumer's record well before the loan is

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[126] § 43(g)(3).

[127] § 43(g)(4).

[128] New § 25(c)(3); TILA § 130(e).

[129] § 25(a).

[130] *Final Release* at 54 (emphasis added).

[131] New § 25(c)(3).

consummated, the Bureau believes that "establishing a single, clear start to the period" will "reduce [the] compliance burden."[132]

New Comment 25(c)(3)-1 clarifies that a creditor "need not retain actual paper copies" as long as it can "reproduce such records accurately." Thus, a creditor could maintain electronic records to satisfy this requirement. By way of example, the Bureau explained that if a creditor relied on a consumer's IRS Form W-2 to verify income, it must be able to reproduce the actual IRS Form W-2, and not merely the information that was contained on the form.[133]

E. Evasion

The Rule prohibits a creditor from structuring a loan as an open-end plan to evade its requirements (and other requirements applicable to closed-end credit in Regulation Z).[134]

V. Concurrent Proposal Matters Not Addressed Above

A. Additional Exemptions From the Rule

1. Credit Extended Under a Community-Focused Lending Program Administered by a Housing Finance Agency

The Proposal would exempt from the Rule extensions of credit made under a program administered by a Housing Finance Agency ("HFA").[135] The Bureau reasoned that "this exemption may be necessary to preserve access to credit for low- to moderate-income ("LMI") consumers."[136]

HUD's regulations defines an HFA as "any public body, agency, or instrumentality created by a specific act of a State legislature or local municipality empowered to finance activities designed to provide housing and related facilities, through land acquisition, construction or rehabilitation."[137] HFAs provide different forms of community-focused lending programs, such as housing counseling services, downpayment assistance, and full mortgage loan financing. HFAs may partner with creditors, such as local banks that extend credit in accordance with the HFA's program guidelines.[138] Thus, for-profit creditors that participate in HFA programs may benefit from this exemption.

[132] *Final Release* at 55.

[133] New Cmt. 25(c)(3)-1.

[134] § 43(h); New Cmt. 43(h)-1.

[135] Proposed § 43(a)(iv).

[136] *Concurrent Proposal Release* at 3.

[137] 24 C.F.R. § 266.5.

[138] *Concurrent Proposal Release* at 31.

2. Credit Extended by Certain Nonprofit Creditors

The Proposal also would exempt from the Rule extensions of credit made by four types of nonprofit creditors. Specifically, a creditor designated as a Community Development Financial Institution ("CDFI"),[139] a Downpayment Assistance Through Secondary Financing Provider ("DAP"),[140] a Community Housing Development Organization ("CHDO")[141] and a creditor designated as a nonprofit organization under section 501(c)(3) of the Internal Revenue Code would be eligible for this proposed exemption.[142]

Creditors must satisfy certain requirements to be eligible for the exemption. Specifically, in the preceding calendar year, a creditor cannot have extended credit secured by a dwelling more than 100 times, and must extend credit only to consumers whose incomes do not exceed the qualifying limit for moderate-income families, as specified by HUD. These creditors are also required to determine, in accordance with written procedures, that the consumer has a reasonable ability to repay the loan.[143]

3. Extensions of Credit in Connection with Certain Homeownership Stabilization and Foreclosure Prevention Programs

The Bureau also proposes to exempt from the Rule extensions of credit that are made under an Emergency Economic Stabilization Act ("EESA") program, such as loans extended under a state Hardest Hit Fund ("HHF") program.[144] The Bureau expressed a concern that "requiring credit extended pursuant to these programs to comply with the ability-to-repay provisions may unnecessarily interfere with these programs' unique underwriting requirements.[145]

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[139] A CDFI, as defined under 12 C.F.R. § 1805.104(h), is an entity with a primary mission of promoting community development that meets certain eligibility requirements described in 12 C.F.R. § 1805.200. CDFIs are approved by the U.S. Department of the Treasury to receive monetary awards from the Treasury's CDFI Fund, which was established to promote capital development and growth in underserved communities. As of July 2012, the Bureau estimated that there were 999 CDFIs in the U.S.

[140] DAPs are nonprofit entities engaging in affordable housing activities as designated by HUD. *See* 24 C.F.R. § 200.194(a). The Bureau estimates that there were 233 DAPs as of November 2012.

[141] A CDHO is a private nonprofit organization certified by HUD that provides housing services for low-income communities and receives grants through HUD's HOME Investment Partnership Program, which provides grants to promote homeownership activities. *See* 24 C.F.R. § 92.2.

[142] Proposed § 43(a)(v)(A)-(D).

[143] Proposed Cmt. 43(a)(3)(v)(D).

[144] Proposed § 43(a)(3)(vi).

[145] *Concurrent Proposal Release* at 5.

4. Federal Agency or GSE Refinancing Programs

The Bureau proposes to exempt from the Rule refinances that are eligible to be insured, guaranteed, or made under a program administered by the FHA, VA or USDA.[146] As proposed, this exemption would be available until these agencies promulgate their own ATR requirements. In addition, the Bureau is proposing to exempt refinances that are eligible to be purchased or guaranteed by a GSE if the refinance is made pursuant to an eligible, targeted refinancing program, as defined under FHFA regulations. The proposed exemption for GSE refinances would only apply if the loan that is to be refinanced is owned by a GSE and was originated prior to the Rule's effective date. The GSE refinancing exemption would expire at the earlier of the termination of the FHFA conservatorship or receivership or in seven years.[147]

B. Small Creditor Portfolio Loans as QMs

The Bureau proposes to define a new but narrow category of QMs: certain loans that are made and held in portfolio by certain small creditors.[148] To qualify for the rule, the creditor:

- must have had total assets of $2 billion or less as of the end of the preceding calendar year; and
- together with its affiliates, may not have originated more than 500 first-lien loans covered by the Rule in the prior calendar year.

Under this provision, small creditors would not need to follow Appendix Q or the 43% DTI limit in underwriting the loan, so long as they satisfied the other QM requirements. Further, the Bureau proposes to increase from 1.5% to 3.5% the amount by which the APR of these loans could exceed the APOR and still benefit from the QM safe harbor.

Generally, these loans must be held in portfolio by these small creditors in order for the loan to maintain its QM status. Thus, subject to limited circumstances, a loan would lose its QM status if it is sold, assigned or otherwise transferred to another person.[149] The Proposed commentary describes the circumstances under which a loan may retain QM treatment upon a transfer.[150]

C. Higher Priced Covered Transaction Threshold for Balloon-Payment QMs

The Bureau also proposes an amendment to the Rule provision that will allow small creditors operating in rural or underserved areas to make balloon-payment QMs. Specifically,

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[146] Proposed § 43(a)(3)(vii)-(viii).

[147] Proposed § 43(a)(3)(viii)(D)-(E)

[148] Proposed § 43(e)(5).

[149] Proposed § 43(e)(5)(ii); Cmt. 43(e)(5)-5.

[150] Proposed Cmt. 43(e)(5)-5 to -10.

the proposal would allow such creditors to make a first-lien, balloon-payment QM with an APR up to 3.5% above the APOR and still benefit from the QM safe harbor.[151]

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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.

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151 Proposed § 43(b)(4).