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Was Chicken Little An Optimist?

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The Consumer Financial Protection Bureau ("CFPB") issued a true game changer on January 10, 2013, with its Ability to Repay and Qualified Mortgage Rule (the "Final Rule" or the "Rule").[1] Some industry observers seem to consider Chicken Little an optimist—not only is the sky falling, but the earth is trembling and the seas boiling. But everyone appears to agree that the Rule has caused the ground to shift beneath our feet. As we describe in this Client Alert, the Final Rule will almost certainly result in fewer borrowers qualifying for mortgages, and will likely result in higher interest rates for many who do qualify.

Concurrent with the issuance of the Final Rule, the CFPB issued *Proposed Amendments to the Ability to Repay Standards under the Truth in Lending Act (Regulation Z)* (the "Concurrent Proposal").[2] Even if the CFPB follows through on all of the proposed amendments, the mortgage banking industry—and consumers—will face a very changed lending environment.

The Rule is likely to negatively impact:

- Loans to borrowers who do not have stellar credit, whose debt-to-income ("DTI") ratios exceed the 43% cap for loans entitled to a safe harbor, or who otherwise do not meet the Qualified Mortgage ("QM") safe harbor standards, since risk-based pricing is likely to result in higher interest rates for those loans. (Ironically, in an attempt to promote lending to borrowers with less-than-stellar credit, Obama Administration housing officials recently asked the Justice Department to provide assurances to lenders that they will not face legal or financial consequences if they make loans to riskier borrowers that meet government standards, but later enter default.)
- Loans to protected classes under fair lending laws, since many consumers who are members of protected classes are unlikely to satisfy the safe harbor criteria, particularly if risk-based pricing results in higher interest rates (particularly if those rates exceed federal and state high cost loan limits).
- Brokers, many of which charge fees of 2% or even 3%, almost guaranteeing that brokered loans will not qualify for QM treatment because they exceed the 3% points and fees maximum.
- Lenders and brokers that use affiliates to provide settlement services and thus have even less pricing flexibility because they must include affiliate fees in the points and fees calculation.
- Jumbo loans (*i.e.*, loans with principal balances above the Fannie Mae and Freddie Mac conforming limits) with DTI ratios above the 43% safe harbor QM limit.
- Interest-only and balloon loans, which many high-net worth consumers prefer for tax purposes. The decreased availability of these loans will further constrict the jumbo loan market.
- Smaller balance loans that are above the $100,000 loan amount to which the 3% points and fees test applies, but that are still below a loan amount at which the points and fees test results in an unrealistically low dollar amount.

I. General Rule

The Dodd-Frank Act added a new section 129C to the Truth in Lending Act ("TILA"), which requires creditors to determine a consumer's ability to repay ("ATR"). The Final Rule (which revises and adds to TILA's implementing regulation, Regulation Z) imposes one basic, overarching rule in this regard. For any covered transaction, the 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."[3]

A creditor can satisfy this requirement in one of four ways, each of which we will address in more detail in this Client Alert:

- First, by considering repayment ability in light of eight underwriting factors, with verification of each of the factors (the "8 Factor Test"). (A creditor need not satisfy this test if it satisfies any of the three following tests.)
- Second, by satisfying a QM test which provides the creditor either a safe harbor or a rebuttable presumption against a violation, depending on the pricing of the loan.
- Third, by refinancing a non-standard mortgage (essentially a non-traditional loan product such as a hybrid ARM or a loan with an interest-only or negative amortization feature) into a standard mortgage.
- Finally, for certain small creditors, by making a qualifying balloon mortgage in a rural or underserved area.

II. Effective Date

The Final Rule applies to loans for which the creditor receives an application on or after January 10, 2014.[4] Creditors might find this a difficult deadline, considering the need for significant changes to software (whether programmed internally or by a third-party loan origination system vendor) and disclosure forms, revisions to policies and procedures (which will be necessary to comply with the CFPB's compliance management expectations), employee training, and systems testing.

III. Covered Loans

The Dodd-Frank Act also added new TILA section 103(cc), which defines a "residential mortgage loan."[5] The Final Rule implemented this provision by applying the Rule to all consumer-purpose, first- and junior-lien, closed-end mortgage loans secured by a dwelling, including home purchase, refinance and home equity loans.[6] In turn, a "dwelling" is defined as any residential structure with one to four units, regardless of whether the structure is attached to real property, such as a condominium or cooperative unit, mobile home, and trailer (if used as a residence).

The following are excluded from the ability to repay requirements:

1. Open-end credit such as home equity lines of credit ("HELOCs"). Note that the CFPB adopted an anti-evasion provision which forbids the structuring of credit that does not meet the definition of open-end credit as an open-end plan in order to evade the Final Rule's requirements. The CFPB intends to monitor this HELOC exemption, presumably to see if it should be included as a covered transaction.

2. Timeshare mortgages.
3. Reverse mortgages.
4. Temporary or "bridge" loans with a term of 12 months or less, including a loan to purchase a new dwelling where the consumer plans to sell another dwelling within 12 months.
5. Consumer credit transactions secured by vacant land.[7]
6. Loan modifications, except in the unusual circumstance that the modification is considered a "refinancing" under Regulation Z.[8]
7. Business-purpose loans, even if secured by a dwelling.[9]

There are two types of QM—or stated more precisely, one type of QM that is entitled to a safe harbor and another that is subject only to a rebuttable presumption. To fall under the QM safe harbor, the APR on a first lien loan must be within 1.5 percentage points of the "average prime offer rate" ("APOR") as of the date the interest rate is set, while the APR on a junior lien must be within 3.5 percentage points of the APOR. Loans in excess of those rates are entitled only to a rebuttable presumption of compliance.[10] Of course, both the safe harbor and rebuttable presumption, which we will address in more detail below, apply only if the creditor satisfies the applicable provisions of the Rule.

IV. The 8 Factor Test (or General Final Rule)

A. Who Will Make Loans Under the 8 Factor Test?

The 8 Factor Test is the general rule, which is not entitled to either a safe harbor or a rebuttable presumption, while the other three methods of satisfying the Rule serve as exceptions to the general rule.

The common wisdom is that because both the safe harbor and rebuttable presumption will attach only to QMs, creditors will be willing to make only QMs. In short, while there is nothing in the Rule prohibiting a lender from making a non-QM, to mitigate potential liability and ensure salability, many industry observers believe that creditors will opt to make only QMs or loans that otherwise are excepted from the 8 Factor Test. That will certainly be the case for many lenders, but there are likely to be exceptions. As just one example, some portfolio lenders may want to continue to offer interest-only loans to highly qualified borrowers who want those loans for tax purposes. The 8 Factor Test might also be useful to a lender who intends a loan to be a QM, but wants to mitigate its risk should the loan's QM status be challenged.

B. The Eight Underwriting Factors

The 8 Factor Test imposes two requirements—creditors must underwrite the loans following the eight factors established under the Rule, and they also must verify the information upon which they rely.

To meet the 8 Factor Test, creditors must underwrite and verify the following, at a minimum:

1. Current or reasonably expected income or assets, other than the value of the dwelling.
2. Current employment status (if the creditor relies on employment income).
3. Monthly payment on the covered transaction.
4. Monthly payment on any "simultaneous loan" of which the creditor is (or should be) aware.

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5. Monthly payment for mortgage-related obligations.
6. Current debt obligations, alimony, child support.
7. Monthly DTI ratio or residual income.
8. Credit history.[11]

While there are numerous underwriting and verification requirements, these requirements do not contain much detail, unlike the QM test. For example, the 8 Factor Test does not specify a DTI ratio or address how credit history should be weighed against other factors. And, again, unlike the QM test, the 8 Factor Test contains no limits on points and fees or on most product features.

The 8 Factor Test also permits creditors to develop their own underwriting standards and make changes over time in response to empirical information and changing economic and other conditions.[12] So creditors have a modicum of flexibility in developing their underwriting and processing criteria, including, for example, by referring to Fannie Mae and Freddie Mac guidance. But it is important to keep in mind that each of the eight factors is subject to the general requirement that the creditor have a reasonable and good faith basis for relying on information it uses to verify satisfaction of the factors. With this flexibility comes potential regulatory and litigation risk, since both regulatory agencies and plaintiffs' lawyers might assert that creditors failed to meet the Rule's "reasonableness" and "good faith" standards in exercising such flexibility. In fact, it should surprise no one if plaintiffs' lawyers assert this even when the creditor did in fact satisfy both requirements.

Current or reasonably expected income or assets, other than the value of the dwelling

The Commentary published with the Final Rule provides examples of types of income the creditor may consider, including salary, wages, self-employment income, military or reserve duty income, tips, commissions, and retirement benefits.[13] The creditor need not document and verify every aspect of the consumer's income, just enough to support the creditor's good faith determination.[14] So, for example, in the case of joint applicants, if one applicant's income is sufficient, the creditor need not consider the other applicant's income. Or if the applicant's employment income is sufficient, the creditor need not consider other sources of income. A creditor also may choose not to consider income, but rather base its determination only on the applicant's assets (excluding the property that will secure the loan).[15]

If the creditor relies on income, the creditor must reasonably expect that the income will be available for repayment (and verify that with third-party records as described below).[16] Examples of reasonably expected income include a salary from a job verified by the employer in writing and expected bonuses verified with documents demonstrating past bonuses.[17] The Commentary permits a creditor to verify a reasonable expectation of an increase in the consumer's income, but that consideration must be based on the consumer's income history, not the source of the income, such as public assistance (the Equal Credit Opportunity Act prohibits a creditor from taking into account whether an applicant's income derives from any public assistance program). The Commentary also provides examples of assets the creditor may consider, including funds in a savings or checking account, amounts vested in a retirement account, stocks, and bonds.[18] This list of assets is illustrative only; a creditor may consider other types of assets.

Current employment status, if the creditor relies on employment income

A creditor must use a consumer's current employment status, but only if the creditor relies on the consumer's employment income in determining the consumer's repayment ability.[19] The CFPB gives

as an example a creditor that relies solely on a consumer's investment income to determine repayment ability and states that the creditor need not verify or document employment status in this instance.[20] It remains to be seen how a lender can reasonably and in good faith determine that investment income will continue at a particular level.

Monthly payment on the covered transaction

Creditors must consider the monthly payment in underwriting a covered loan.[21] The CFPB offers no meaningful discussion of this factor, other than to note that it is to be calculated in accordance with proposed Regulation Z § 1026.43(c)(5).[22] Subject to a few exceptions, the creditor must assume that the loan is repaid in substantially equal, monthly, fully amortizing payments for principal and interest over the entire term of the loan, with no balloon payment, and that the interest rate is fixed over the entire term of the loan (for adjustable rate mortgage loans, that fixed rate must be the greater of the fully indexed rate (without considering periodic interest rate caps or the introductory rate).[23] The method for determining monthly payment is discussed in more detail in our discussion of QMs below.

Monthly payment on any "simultaneous loan" that the creditor knows or should have known of

Yet another factor a creditor must consider is the consumer's monthly payment on any simultaneous loan that the creditor knows of (or has reason to know of).[24] A simultaneous loan includes any covered transaction or HELOC that will be made to the same consumer at or before consummation of the covered transaction and secured by the same dwelling that secures the covered transaction. These primarily are piggyback, junior-lien loans secured by the same property and include even HELOCs and loans closed by another creditor. The CFPB noted, however, that the creditor is not required to investigate to determine whether there is a simultaneous loan, beyond reasonable underwriting policies and procedures.[25] But this information is likely to be uncovered in the underwriting or closing process.

Monthly payment for mortgage-related obligations

There are numerous requirements that attach to the lender's obligation to consider monthly payment for mortgage-related obligations.

For example, if a consumer is required to pay mortgage insurance premiums on a monthly, annual, or other basis after consummation, the creditor must include these recurring mortgage insurance payments. However, the creditor is not required to include an up-front, one-time fee for mortgage insurance or similar purposes imposed at consummation.[26]

If the consumer will satisfy the obligation to make payments to community governance associations, such as homeowners associations, with recurring payments after consummation, the creditor must include the obligation in the evaluation—even if the obligation is escrowed. However, creditors need not include payments to community governance associations, such as homeowners associations, if the obligations are fully satisfied at or before consummation. Nor is the creditor required to include these payments in the evaluation if the consumer finances the obligation. Essentially, the same rules apply to special assessments known by the creditor. The creditor will be deemed to have complied with this requirement by relying on estimates prepared by the homeowners association or representations of other reliable parties.[27]

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There are other nuances, so creditors who rely on the eight factors should study this aspect, as well as all others, carefully.

Current debt obligations, alimony, child support

Creditors must consider current debt obligations, such as student loans, automobile loans, revolving debt, and existing mortgages (this is not an exhaustive list), as well as alimony and child support.[28]

The CFPB explains that creditors 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."[29] For example, a creditor may take into account that an existing mortgage is likely to be paid off soon after consummation because there is an existing contract for sale of the property that secures that mortgage. On the flip side of the coin, creditors should consider when forbearance or deferral periods will expire.[30]

Monthly DTI ratio or residual income

The consumer's monthly DTI ratio or residual income must also be considered—the creditor may consider either or both.[31] But again, the CFPB purports to offer a great deal of flexibility in determining what is debt and income. For example, creditors may consider compensating factors in addition to the DTI or residual income in assessing a consumer's repayment ability, subject to the reasonable and good faith standard.[32] The 8 Factor Test's DTI standard is qualitative rather than quantitative, unlike the 43% DTI standard applicable to QMs, discussed below.[33]

Credit history

Finally, creditors must consider the borrower's credit history.[34] The Commentary clarifies that the Final Rule does not require creditors to obtain or consider a consolidated credit score or prescribe a minimum credit score that creditors must apply.[35] In fact, the Rule specifies that creditors 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 the ability to repay. The CFPB classifies this as flexibility, but it likely also is an invitation for litigation.

C. Verification

Creditors must make a reasonable and good faith determination that a consumer has a reasonable ability to repay a covered transaction, based on "verified and documented information."

This requirement is much more stringent than the Home Ownership and Equity Protection Act's existing requirement, which requires only verification of a consumer's income or assets. For the most part, creditors are to use third-party records, which include documents or other records 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. Third-party records may also come from the consumer, provided they are reasonably reliable and specific to the individual consumer, such as payroll statements received from the consumer.

The types of verification suggested for each of the eight factors vary and are flexible. One example is a credit report, which may be used to establish not only credit history and repayment risk, but the existence and amount of a debt (to the extent that that debt is noted on the report). But a creditor cannot rely on a credit report if the creditor knows or has reason to know the report is inaccurate. Other verification examples include copies of tax returns filed with a taxing authority, such as the IRS,

and records from a government agency of the amount of any benefit payments or awards, such as a "proof of income letter" issued by the Social Security Administration.

V. Qualified Mortgages

One of the most debated issues prior to the issuance of the Final Rule was whether the CFPB would give creditors making a QM a safe harbor from liability, or merely a rebuttable presumption of compliance. The CFPB split the baby, incorporating both a safe harbor and a rebuttable presumption. Prime QMs with annual percentage rates that do not exceed the higher-priced mortgage loanAPOR thresholds will be entitled to a safe harbor, *i.e.*, they will be deemed to comply with the ATR requirement.[36] Higher-priced QMs will enjoy only a rebuttable presumption of compliance. The CFPB has essentially given the prime loan market a safe harbor and the non-prime market a rebuttable presumption.

The safe harbor establishes a conclusive presumption that is intended to permit a creditor to refute a claim that the creditor violated the Rule by establishing that the loan is a QM. Stated differently, by originating a QM, the creditor will not need to show that it verified the consumer's ability to repay the loan, but rather only must show that the loan is a QM with an APR below the APOR thresholds. However, if a loan falls in the "rebuttable presumption" category, a borrower may rebut the presumption by showing that the creditor did not make a reasonable and good faith determination of the consumer's ability to repay, even though the loan met the QM requirements. This consumer conceivably could rebut the presumption by showing that the consumer's income, debt obligations, monthly payment, etc. would leave the consumer with insufficient residual income (or assets) to pay their loan and other living expenses.

The Supplementary Information that accompanies the Final Rule makes clear that oral communications between a borrower and creditor may factor into the underwriting analysis for purposes of determining QM status:

> A consumer may seek to show that a loan does not meet the requirements of a qualified mortgage by relying on information provided orally to the creditor or loan originator to establish that the debt-to-income ratio was miscalculated. Alternatively, a consumer may seek to show that the creditor should have known, based upon facts disclosed orally to the creditor or loan originator, that the consumer had insufficient residual income to be able to afford the mortgage.[37]

The introduction of oral evidence offers borrowers the ability to rebut the presumption of compliance, even if the creditor complied in all respects with the Rule. In short, every higher-priced QM that a creditor originates will be subject to a highly fact-based attack. However, the CFPB recognizes that the longer the consumer has demonstrated an actual ability to repay (*i.e.*, by making timely payments without modification or accommodation) the less likely the consumer will be able to rebut the presumption of compliance.[38] As such, creditors may take some solace in knowing that a borrower's ability to mount a fact-based challenge regarding a loan's QM status may diminish over time, at least in some circumstances.

Ultimately, it remains an open issue how much more beneficial the safe harbor will be than the rebuttable presumption. As just one example, it seems possible that a borrower's attorney could be able to defeat a Motion to Dismiss or state law equivalent merely by pleading that the borrower's DTI exceeds 43 percentage points.

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Below we address the contours of the QM, the sticking points that might make it difficult for creditors to stay within those contours, and the extent to which those contours provide or fail to provide certainty to creditors.

A. Defining QMs

As discussed in the following section, there are three categories of QMs: (a) the "standard" QM, which must meet standards regarding product features, debt and fee limits, and other underwriting standards; (b) a temporary QM for loans eligible for purchase, insurance, or guaranty by certain governmental and quasi-governmental agencies; and (c) a balloon-payment QM, applicable to loans made by small, portfolio creditors in rural or underserved communities. There is also an exemption from the ATR requirements for certain same-creditor refinancings. We address each of these varieties below.

B. Standard QM

A loan will fit within the standard QM definition and the safe harbor if (a) it satisfies the following features, and (b) its APR does not exceed the APOR by more than 1.5 percentage points for a first-lien loan, or 3.5 percentage points for a subordinate-lien loan. If the loan's APR exceeds those thresholds, it will be entitled to only a rebuttable presumption of compliance.

1. Regular periodic payments. QMs must have substantially equal, regular payments (aside from the effect that any interest rate change after consummation has on the payment in the case of an adjustable-rate or step-rate mortgage). Congress and the CFPB chose to exclude loans with negative amortization, interest-only payments, or balloon payments on the belief that such products can lead to unacceptable payment shock. Therefore, except as discussed below with respect to Balloon-Payment QMs, the Final Rule provides that a QM's regular periodic payments must not:

- Result in an increase in the principal balance;
- Allow the borrower to defer repayment of principal; or
- Result in a balloon payment.

While loans with these features may not be appropriate for all borrowers, they often may be a legitimate choice for certain qualified borrowers. However, creditors will make such loans only if the creditors (and their investors) are willing to take their chances by underwriting the loans to the 8 Factor Test. And if they do so, they likely will have to price the loans to reflect the uncertainty of the loans being entitled to neither a safe harbor nor a rebuttable presumption of compliance.

2. Maximum 30-year loan term. A QM may not have a loan term greater than 30 years. This prohibited loan feature comes directly from the Dodd-Frank Act QM definition.[39] The CFPB explains that loans with longer terms are rare and that, when made, generally are for the convenience of consumers who could qualify for a loan with a 30-year term.[40] Thus, the CFPB saw no need to stray from the statute.

3. **Three percent limitation on points and fees for loans greater than or equal to $100,000 (different limitations apply with respect to smaller loan amounts).[41]** For a loan with an original principal balance of $100,000 or more to qualify for QM treatment, the borrower must not pay points and fees greater than 3% of the total loan amount. As addressed in more detail below, while the calculation of points and fees for purposes of this QM limitation excludes certain bona fide discount points and amounts for upfront mortgage insurance, the calculation includes (among other amounts):

(a) certain fees paid to affiliates; (b) mortgage originator compensation paid directly or indirectly by the creditor or the consumer; and (c) amounts imposed by secondary market investors and passed through to borrowers to compensate for credit risk, which commonly are referred to as loan level price adjustments ("LLPAs"). The newly expansive definition of points and fees will make it difficult for many loans to stay within the 3% limit. (Even Fannie Mae and Freddie Mac historically have allowed points and fees up to 5%.)

4. **Underwriting based on amortizing payments and maximum rates**.[42] Both the Dodd-Frank Act and Final Rule prohibit a creditor from underwriting a loan using a lower introductory rate (*e.g*., on adjustable rate mortgages) and from excluding required escrow payments from DTI. Further, when underwriting a QM, the creditor must take into account both the monthly payment for the loan, in addition to all mortgage-related obligations, using:

> (a) The maximum interest rate that may apply during the first five years after the date on which the first regular periodic payment will be due; and
>
> (b) Periodic payments of principal and interest that will repay either:
>
> > (i) the outstanding principal balance over the remaining term of the loan as of the date the interest rate adjusts to the maximum interest rate that may apply during the first five years after the date on which the first regular periodic payment will be due, assuming the consumer will have made all required payments as due prior to that date; or
> >
> > (ii) the loan amount over the loan term.

By comparison, when following the 8 Factor Test, a creditor must consider monthly payments using the fully indexed rate (or any introductory rate, whichever is higher).[43] (The CFPB recognizes that, under certain circumstances, the rate that a creditor must consider when underwriting a QM may be lower than the rate it may consider when following the 8 Factor Test.)

5. Verification of income/assets. To satisfy the QM requirements, the creditor must consider and verify, at or before consummation, the consumer's current or reasonably expected income and assets, other than the value of the dwelling (including any real property attached to the dwelling) that secures the loan. The Final Rule mandates that the creditor follow income and asset verification requirements set forth in the Final Rule and accompanying Appendix Q (which is long—over 35 pages—and very complicated). Like the 8 Factor Test, the creditor making a standard QM must verify income or assets using third-party records that provide reasonably reliable evidence of the consumer's income or assets.

6. Verification of debt obligations. To originate a QM, the creditor must also consider and verify the consumer's current debt obligations, alimony, and child support in accordance with requirements specified in the Final Rule and accompanying Appendix Q, using reasonably reliable third-party records.

7. Maximum DTI ratio of 43 percent at the time of consummation. The Dodd-Frank Act contemplated the establishment of ratios or residual income standards for QMs. Although the rule proposed by the Federal Reserve Board that led to the Final Rule (the "Proposed Rule") did not include this requirement, the CFPB reopened the comment period on the Proposed Rule last summer to gather performance data related to DTI ratios and solicit additional public input on whether the CFPB should establish a bright-line test. Some members of the mortgage industry argued in favor of the certainty of a bright-line test, while others stressed that underwriting requires the weighing of compensating factors. Ultimately, the CFPB opted for a 43 percent DTI ratio requirement, noting that it would: (a) protect consumer interests, since DTI ratios are a common and important tool for

evaluating consumers' ability to repay their loans (and the specific 43 percent standard reflects longstanding FHA guidance regarding general affordability); (b) provide certainty for creditors to help minimize disputes and litigation as to whether a loan is a QM; and (c) make room for a "vibrant market" for non-QMs over time.[44] While many creditors and investors have relied upon DTI ratios, it is likely that a 43 percent DTI ratio requirement will prevent creditworthy borrowers from meeting the QM test (*e.g.*, jumbo loan borrowers with assets sufficient to repay the loan). These borrowers might still be able to obtain loans, but it is likely they will pay higher rates, notwithstanding their clear ability to repay.

C. The Sticking Points (and Fees)

It will be difficult for creditors to keep many loans under the 3 percent points and fees threshold. While the concept of a points and fees limitation is not new (the test for a high-cost or "HOEPA" loan under both federal and state requirements includes a points and fees threshold),[45] this limitation does not appear to have any relationship to a borrower's ability to repay his or her loan. The CFPB nevertheless considers a points and fees test to be an important proxy, on the theory that when creditors and loan originators receive more compensation via points and fees, they are less concerned with the consumers' ability to repay.[46] Moreover, the CFPB believes that Congress clearly sought to discourage significant non-interest charges, perhaps believing it is generally preferable for borrowers to pay for the cost of credit over time through a higher interest rate.

In defining "points and fees" for the QM rule, the CFPB started with the base of the existing definition of "points and fees" under HOEPA, and then made adjustments based on the Dodd-Frank Act's statutory definition. The Bureau also used its discretionary authority to interpret and provide exceptions to conflicting statutory language to shore up the treatment of certain categories of fees. Most of the CFPB's interpretations appear to relate to reconciling potential conflicts between general and specific statutory elements of the "points and fees" definition.[47] While the final definition loosely resembles what lenders may have been familiar with in the context of high-cost mortgages, the Rule's definition is more expansive, particularly with respect to loan originator compensation and prepayment penalties.[48] And while the HOEPA definition recognizes only those "points and fees" charged at or before closing,[49] for QM loans the Final Rule includes all points and fees "known at or before consummation."[50] This timing rule is subject to two exceptions—private mortgage and credit insurance, which are includable only if paid at or before consummation,[51] and mortgage originator compensation that is attributable to the transaction, which is includable whenever it is paid, but only to the extent that it is known at the time the interest rate on the loan is set.[52]

In light of the expansive definition of "points and fees" (especially with respect to loan originator compensation), creditors will likely be forced to include some charges in the loan's interest rate. This is especially true with respect to smaller loan amounts. Higher interest rates may, of course, have the perverse effect of pushing these loans into the "higher price" category, or even into HOEPA territory (which is being expanded through a separate rulemaking). This, in turn, could result in the loan falling out of the QM safe harbor and perhaps into the Rule's rebuttable presumption territory. This assumes, of course, that creditors will be able to stay within the 3 point threshold in the first place. If they can not, the creditor will be relegated to the amorphous 8 Factor Test.

1. Charges included as "points and fees"

The Final Rule generally includes the following items in the definition of "points and fees" (subject to the exclusions described below): (a) items included in the TILA finance charge, other than interest or the time-price differential; (b) all compensation paid directly or indirectly by a consumer or creditor to a loan originator (whenever payable) that can be attributed to that transaction at the time the interest rate is set; (c) all items listed in 12 C.F.R. § 1026.(4)(7) (other than amounts held for future payment of taxes), unless the charge is reasonable, the creditor receives no direct or indirect compensation in connection with the charge, and the charge is not paid to an affiliate of the creditor; (d) premiums or other charges payable at or before consummation for any credit life, credit disability, credit unemployment, or credit property insurance, or any other life, accident, health, or loss-of-income insurance for which the creditor is a beneficiary, or any payments directly or indirectly for any debt cancellation or suspension agreement or contract; (e) the maximum prepayment penalty that may be charged or collected under the terms of the mortgage loan; and (f) the total prepayment penalty incurred by the consumer if the consumer refinances the existing mortgage loan with the current holder of the existing loan, a servicer acting on behalf of the current holder, or an affiliate of either.

a. Finance charges

The Rule effectively uses the TILA finance charge as the base for its points and fees calculation. Charges are includable as points and fees if they are "included in the finance charge under [12 C.F.R.] § 1026.4(a) and (b)," unless otherwise expressly excluded.[53] The Bureau noted that the more inclusive definition of the finance charge in its 2012 TILA-RESPA integration proposal could bring additional charges into the definition of "finance charge," but deferred any decision on whether to adjust the "points and fees" definitions or thresholds to mitigate the impact of any expansion of the finance charge definition coverage until it finalizes that proposal.

b. Loan originator compensation

"Points and fees" also include "[a]ll compensation paid directly or indirectly by a consumer or creditor to a loan originator . . . that can be attributed to the transaction at the time the interest rate is set."[54] The term "loan originator" includes any "person who for compensation or other monetary gain, or in expectation of compensation or other monetary gain, arranges, negotiates, or otherwise obtains an extension of consumer credit for another person," including the creditor in a table-funded transaction.[55]

The Bureau provides illustrative examples of the forms of loan originator compensation that generally will be included in "points and fees." Certain forms of compensation are excluded because they can not be attributed to the specific transaction (*e.g.*, the base salary of an originator employed by the creditor).[56] Other forms of compensation are excluded because they cannot be determined at the time the interest rate for a loan is set. For example, a bonus paid to a loan originator for the quality or overall performance of a loan portfolio would be excluded.[57] However, any loan originator compensation that can be attributed to the transaction at the time the interest rate is set must be included in points and fees. This expansive approach could include any loan-specific hourly compensation or any "bonus, commission, yield spread premium, or award of merchandise, services, trips or similar prizes."[58]

The inclusion of loan originator compensation raises significant practical concerns. First, it disadvantages brokers, since creditors may recover their overhead through the interest rate, while all broker compensation (which includes an overhead component) is included in the definition of "points

and fees."[59] Second, it results in double-counting of broker compensation, either as an included finance charge (and, separately, as loan originator compensation), or as compensation both to the individual loan originator and to the brokerage firm for which the originator works.[60] This is a particular concern for the wholesale market, since broker fees alone may push a loan to the edge of – or over – the QM thresholds. Third, it imposes recordkeeping and accounting burdens on creditors to monitor the compensation originators receive on a per-transaction basis, including the compensation received by the individual loan originators of a brokerage firm and the number of hours worked by an hourly-paid loan originator on each loan file.[61]

The Bureau recognizes these issues, particularly with respect to double-counting (or what the CFPB terms the "additive approach"). But for now, the CFPB has finalized the QM rule without qualifying the harsher effects of the statutory language.[62] Instead, the Bureau suggests potential resolutions to the double-counting issue in the Concurrent Proposal, which would exclude compensation paid to individual loan originator employees and compensation that already has been counted because it is part of the finance charge.[63]

c. *Real estate related fees*

All real estate related fees listed in 12 C.F.R. § 1026.4(c)(7) (except amounts held for the future payment of taxes) generally are treated as "points and fees," unless they are reasonable and no compensation is received by the creditor, originator, or the affiliate of either for the charge.[64] The CFPB suggests in the Supplementary Information that accompanies the Rule that a charge is generally reasonable if it is the result of an arm's-length transaction. The Bureau further states that the reasonableness requirement is "not intended to invite an inquiry into whether a particular appraiser or title insurance company is imposing excessive charges."[65]

d. *Credit insurance and debt cancellation premiums and charges*

"Points and fees" also include premiums and other charges for "credit life, credit disability, credit unemployment, or credit property insurance, or any other life, accident, health, or loss-of-income insurance *for which the creditor is a beneficiary*."[66] Payments for debt cancellation or suspension agreements are also included. However, unlike most of the other included charges, credit insurance and debt cancellation charges are included only if they are payable at or before consummation. (However, to the extent the creditor collects premiums on a monthly basis, the first monthly payment must be included if it is payable at or before consummation.)

e. *Prepayment penalties*

Two types of prepayment penalties are included in the definition of "points and fees":

- The maximum prepayment penalty that may be charged or collected under the terms of the mortgage loan being originated.[67]
- The total prepayment penalty incurred by the consumer if the consumer refinances the existing mortgage loan with the current holder of the existing loan, a servicer acting on behalf of the current holder, or an affiliate of either.[68]

A "prepayment penalty" for these purposes is a charge, other than a bona fide third-party charge, imposed for prepaying a loan within 36 months after its consummation.[69]

2. Charges excluded from "points and fees"

The Final Rule excludes certain items that would otherwise be included in the finance charge, and by extension, in "points and fees." As previously discussed, one of these items is interest or the time-price differential. The others are: (a) government mortgage insurance or guaranty fees, and private mortgage insurance sharing certain characteristics of government insurance; (b) bona fide and reasonable real estate related fees not paid to the creditor, originator, or an affiliate of either; (c) bona fide third-party charges not retained by the creditor, originator, or an affiliate of either; and (d) certain bona fide discount points. Each of these categories is discussed below.

a. Mortgage insurance and guaranty fees

All federal or state agency mortgage insurance or guaranty fees are excluded from "points and fees."[70] Private mortgage insurance, however, is subject to a more limited exclusion. First, all private mortgage insurance premiums and other charges payable after consummation are excluded.[71] Second, a creditor may exclude the portion of any private mortgage insurance premium or other charge payable at or before consummation to the extent that portion is not in excess of the single payment premium amount payable under FHA's policies in effect at the time of origination,[72] provided that: (a) the premium or charge is required to be refundable on a pro rata basis; and (b) the refund is automatically issued upon notification of the satisfaction of the underlying mortgage loan.[73]

The partial excludability of private mortgage insurance premiums is applicable even to loans not eligible for FHA insurance (*e.g.*, loans that exceed FHA principal limits).[74] Further, when calculating the excludable portion of the premium, the Bureau suggests that a lender can apply the general FHA premium formula to the actual principal amount to determine the maximum excludable premium, even if the principal exceeds FHA limits.[75]

b. Bona fide and reasonable real estate related fees

As discussed above, real estate related fees under 12 C.F.R. § 1026.4(c)(7) are excludable if they are reasonable and are not paid to the creditor, originator, or an affiliate of either.

c. Bona fide third-party charges

Bona fide third-party charges are excludable from "points and fees," provided they are not paid to the creditor, originator, or an affiliate of either. However, if a more specific provision requires inclusion of a charge, that charge must be included. For example, credit insurance charges payable at or before consummation are included in the calculation of "points and fees" even if the charges are payable to a third party.[76] This means that if creditors use affiliated service providers that charge real estate related fees for the services listed in 12 C.F.R. § 1026.4(c)(7), the creditor must include as points and fees the amounts that borrowers pay for those services, even if those amounts are reasonable and despite the fact that creditors using unaffiliated providers need not include those amounts.

Significantly, however, the Bureau chose not to treat LLPAs as excludable third-party fees, thereby requiring creditors to include them in the points and fees calculation (to the extent that such fees are passed through to consumers as a separate charge). LLPAs are amounts that secondary market investors charge to creditors to compensate the investors for loan-level credit risk. Fannie Mae and Freddie Mac post matrices of the amounts, which vary based on factors such as credit score and LTV. Although many lenders simply pass through these charges, the CFPB in the Supplementary Information to the Rule argued that excluding LLPAs from the definition of "points and fees" might

undermine compliance and enforcement. For instance, the Bureau questions whether one could meaningfully distinguish between points charged to offset loan level risk and other points charged on a loan.[77] Although the Dodd-Frank Act allows third-party charges to be excluded, and Fannie Mae and Freddie Mac (the largest purchasers of residential mortgage loans) make their LLPAs public and readily verifiable, the CFPB still declined to exclude them. Accordingly, if a creditor cannot fit those amounts within its 3 percent limit (perhaps due to having packed in loan originator compensation), the creditor's only alternatives appear to be either to charge and exclude bona fide discount points or to charge higher interest rates.

d. Bona fide discount points

CFPB's final rule allows lenders to exclude up to two "bona fide discount points" from the definition of "points and fees."[78] To determine the number of points a lender may ultimately exclude requires a comparison between the interest rate on the loan and the APOR at the time the interest rate on the loan is set.[79] Specifically, if the loan carries an interest rate no more than one percentage point higher than the APOR, a lender may exclude up to two bona fide discount points.[80] If the loan carries an interest rate between more than one, but less than two, percentage points higher than the APOR, the lender may exclude up to one bona fide discount point.[81]

A point is a "bona fide discount point" if it is paid by the consumer to reduce, and actually reduces, the interest rate or time-price differential on the loan by an amount consistent with established industry practices. While the Proposed Rule would have required lenders to consider the value of compensation on the secondary market for originating a loan with a higher interest rate, the Final Rule does not contain that requirement. Instead, secondary market compensation can be used to demonstrate that the amount of the interest rate reduction is in line with industry practices. Lenders may also rely on other evidence, such as the treatment of discount points under rules established by Fannie Mae and Freddie Mac (collectively, the "GSEs").[82]

D. Other QM Varieties

1. Special temporary rules for loans eligible for federal government insurance, guaranty, or purchase

The Final Rule established an alternative to the standard QM definition for loans eligible for purchase, guaranty, or insurance by certain government and quasi-governmental agencies ("Agency QMs").[83] This alternative applies to loans eligible at consummation for purchase, guaranty, or insurance (as applicable) by: (a) Fannie Mae or Freddie Mac, while operating under the conservatorship or receivership of the Federal Housing Finance Agency ("FHFA"); (b) any limited-life regulatory entity succeeding the charter of Fannie Made or Freddie Mac; or (c) FHA, Department of Veterans Affairs ("VA"), Department of Agriculture, or the Rural Housing Service. Although the Proposed Rule did not include this alternative, the Dodd-Frank Act requires those agencies ("Agencies") to prescribe their own QM rules.[84]

The CFPB provided in the Final Rule that certain Agency loans may be deemed a QM without meeting the standard QM's income verification, debt verification, or 43 percent DTI ratio requirements.[85] However, an Agency QM must still meet any verification or other requirements imposed by the Agency. Further, like standard QMs, Agency QMs must be free of certain risky product features (like negative amortization, interest-only payments, or balloon payments) and have a loan term that does not exceed 30 years. Agency QMs are also subject to the standard QM's 3 percent points and fees cap. Prime Agency QMs enjoy the same safe harbor that applies to standard QM

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loans, and higher-priced Agency QMs receive the same rebuttable presumption of compliance as standard QMs.

The Final Rule's provisions pertaining to Agency QMs expire on the earlier of January 10, 2021 (seven years after their effective date) or the date that the agencies issue their own QM rules. Accordingly, for seven years (assuming Fannie Mae and Freddie Mac remain under FHFA conservatorship) or until the agencies establish their own QM rules, approximately 80 percent of the U.S. residential mortgage market[86] will not be subject to the standard QM definition, including its hard-stop 43 percent DTI ratio.

To qualify as an Agency QM, a loan need only be *eligible* for purchase, insurance or guaranty by the government agency or GSE, respectively. According to the Final Rule, a loan is eligible for purchase by Fannie Mae or Freddie Mac if the loan: (a) conforms to the standards set forth in the Fannie Mae Single-Family Selling Guide or the Freddie Mac Single-Family Seller/Servicer Guide; (b) receives an "Approve/Eligible" recommendation from Desktop Underwriter; or (c) receives an "Accept and Eligible to Purchase" recommendation from Loan Prospector.[87] One potential difficulty with this formula is that the GSEs' "standards" address many issues beyond a borrower's repayment ability. For example, Fannie Mae imposes detailed requirements pertaining to loans secured by second homes (*e.g.*, a second home must be a one-unit property and must be located a reasonable distance away from the borrower's principal residence).[88] FHA also imposes detailed property eligibility requirements. For instance, FHA generally imposes strict limits on secondary residences, allowing insurance on loans secured by such properties only in unusual circumstances.[89]

Recognizing this confusion, the CFPB, on April 22, 2013, issued proposed amendments to the Final Rule (the "Proposed Amendments") to clarify that a creditor would not be required to comply with all respective Agency requirements to originate a QM. Specifically, a creditor would not have to comply with certain requirements that are

> [W]holly unrelated to assessing a consumer's ability to repay…such as requirements related to selling, securitizing, or delivering already consummated loans and any requirement that the creditor must perform after the consummated loan is sold, guaranteed, or endorsed for insurance such as document custody, quality control, or servicing.

In the Proposed Amendments, the CFPB acknowledges that disaggregating all Agency guidelines to determine which exact provisions relate to a borrower's ability to repay would be an "extraordinarily complex task" that would defeat the purpose of "adopting widely recognized standards to facilitate compliance and access to responsible credit." Nonetheless, the CFPB proposes that those requirements that are entirely unrelated to underwriting should not affect QM status.

A proposed amendment included in the CFPB's Concurrent Proposal would exempt certain refinancings eligible for purchase by the GSEs from the repayment ability requirements. If the amendment is finalized, it would exempt from the Rule's repayment ability requirement an extension of credit that is a refinancing (by either the same creditor or a different creditor), and that is eligible for purchase or guarantee by Fannie Mae or Freddie Mac, provided that: (a) the refinancing is made pursuant to an eligible targeted refinancing program, as defined under 12 C.F.R. § 1291.1 (including, for instance, the HARP program); (b) Fannie Mae and Freddie Mac are still operating under FHFA conservatorship or receivership on the date the refinancing is consummated; (c) the existing obligation that is refinanced is owned by Fannie Mae or Freddie Mac; (d) the existing obligation that is

refinanced is not consummated on or after January 10, 2014; and (e) the refinancing is not consummated on or after January 10, 2021.[90]

The April 2013 Proposed Amendments would clarify that if a creditor seeks to rely on an Agency automated underwriting system ("AUS") recommendation in determining QM status, it would be required to (1) accurately input the loan information in the automated system; and (2) satisfy any accompanying requirements or conditions to the AUS approval that would otherwise invalidate the recommendation (unless the conditions concern activities related to selling, servicing, securitizing, or delivering consummated loans, or post-consummation requirements). However, the Proposed Amendments would permit a creditor to rely on specific agreements between the creditor and Agency that allow the creditor to deviate from standard Agency requirements in determining QM status. Finally, the Proposed Amendments would clarify that repurchase and indemnification demands by an Agency would not serve as dispositive proof that a mortgage loan did not meet the definition of QM since some demands are unrelated to QM eligibility. Again, the CFPB requests comments on these proposed clarifications.

2. *Balloon-payment QMs (by some creditors)*

The standard and Agency QM definitions exclude residential mortgages with balloon-payment features. This is because balloon loans are generally repayable by borrowers only if they can secure a refinancing when the balloon payment becomes due. However, as Congress recognized in the Dodd-Frank Act,[91] small creditors in rural or underserved communities are under unique competitive and other pressures, and therefore may rely upon balloon-payment mortgages to hedge interest rate risk. The Final Rule addresses this by providing that a balloon-payment loan can receive QM treatment when the following criteria are met:

1. The loan must be made by a small (portfolio) creditor operating predominantly in a rural or underserved area. During the preceding calendar year, the creditor must have: (a) made more than 50 percent of covered transactions secured by a first lien in counties designated by the CFPB as "rural" or "underserved"; (b) total assets of $2 billion or less (adjusted annually for inflation); and (c) together with all affiliates, extended 500 or fewer first-lien covered transactions.
2. The loan must be free of other risky product features, such as negative amortization. The loan term must also not exceed 30 years (with a minimum term of at least five years), and points and fees must not exceed 3 percent.
3. The creditor must consider and verify current or reasonably expected income/assets, current debt obligations, alimony, and child support. However, the creditor need not rely on the Final Rule's Appendix Q (which otherwise contains income and debt verification requirements with respect to other QMs).
4. Although the Final Rule does not establish bright-line tests, the creditor must consider and verify the borrower's DTI/residual income (excluding the balloon payment).
5. Other than the balloon payment, the loan must have substantially equal scheduled payments calculated based on an amortization period that does not exceed 30 years.
6. The interest rate must not increase over the term of the loan.[92]

Additionally, at consummation, the loan must not be subject to a forward commitment to be acquired by another person, other than another small (portfolio) creditor in a rural/underserved area. If the creditor sells, assigns, or otherwise transfers the loan after consummation, the loan would immediately

lose its balloon-payment QM status. There is an exception to this prohibition again post-consummation transfers when the loan is sold, assigned, or otherwise transferred three years or more after consummation, or when the loan is transferred to another small (portfolio) creditor in a rural/underserved area.[93] Prime balloon-payment QMs enjoy the same safe harbor as standard QM loans, and higher-priced balloon-payment QMs the same rebuttable presumption of compliance as a standard QM.

Finally, the Concurrent Proposal includes amendments that would further benefit small (portfolio) creditors. One amendment would enable small (portfolio) creditors serving rural/underserved communities to make first-lien, balloon-payment QMs with an APR up to 3.5 percentage points above the APOR, and still enjoy the standard QM safe harbor (as opposed to APRs up to 1.5 percentage points above the APOR, which is the Final Rule's current standard).[94] Another proposed amendment extends beyond balloon-payment qualified mortgages, and would enable small (portfolio) creditors (regardless of whether they serve rural/underserved areas) to make qualified first-lien mortgages without complying with the 43 percent DTI ratio requirement and Appendix Q.[95] However, the creditor would still have to comply with other standard QM requirements. Those first-lien QMs would not be considered "higher-priced" unless the APR exceeds the APOR by 3.5 percentage points, thus potentially broadening the scope of loans made by small (portfolio) creditors that would be included within the Final Rule's safe harbor of compliance.

3. *Exemption for refinancing nonstandard loans*

The Final Rule provides an exemption from the repayment ability requirements for certain "same-creditor" refinancings of "nonstandard" mortgages into "standard" mortgages. The CFPB included this refinancing incentive in the Final Rule to reduce the likelihood that payment shock will cause borrowers to default on a non-traditional loan product.[96]

A "nonstandard" mortgage eligible for this refinancing exemption includes any adjustable rate mortgage with a fixed rate period of one year or longer (*i.e.*, "hybrid" ARM loans), interest-only loans, or negative amortization loans. The refinancing is eligible for the exemption only if the new loan is a standard mortgage with the following features: (a) regular periodic amortizing payments; (b) no balloon payments; (c) a 3 percent cap on points and fees (to ensure at-risk consumers attain a net benefit from the refinancing); (d) a loan term not exceeding 40 years; (e) a fixed rate for at least the first five years after consummation; and (f) no cash out (*i.e.*, the proceeds must be used only to pay off the outstanding principal balance on the nonstandard mortgage or for closing or settlement charges).[97]

A refinancing of a nonstandard mortgage into a standard mortgage will be exempt from the Final Rule's repayment ability requirements if the following criteria are met:

1. The creditor for the new mortgage loan must be the current holder or servicer acting on behalf of the current holder.
2. The new monthly payments must be materially lower than those under the nonstandard mortgage. The CFPB explains that the point of this exemption is to enable creditors to offer consumers who are facing payment shock a new loan from which they materially benefit, without subjecting the borrowers to full underwriting. The Final Rule adopts a safe harbor for reductions of at least 10%, although the CFPB notes that reductions of less than 10% could nonetheless meet the "materially lower" standard depending on the relevant facts and circumstances.[98]
3. The creditor must have received the application for the refinancing no later than two months after the nonstandard mortgage has "recast."[99]

4. The consumer must have no more than one 30-day late payment during the preceding 12 months. Furthermore, there must have been no 30-day late payments during the preceding six months.
5. If the existing nonstandard mortgage is consummated on or after January 10, 2014 (the effective date of the Final Rule), the nonstandard mortgage must meet the requirements of the Final Rule, in that it must either meet the repayment ability requirements or qualify as a QM. The CFPB explained that this will prevent use of this nonstandard-to-standard refinancing exemption to circumvent or cure violations of the repayment ability requirements.
6. The creditor must consider whether the standard mortgage is likely to prevent a default on a nonstandard mortgage once the loan is recast.

Absent these exigent circumstances, the CFPB believes that creditors must either make a QM or verify that the consumer has the ability to repay the mortgage loan. However, the Concurrent Proposal requests public comment on an exemption for FHA/VA and Fannie/Freddie refinancings.[100] Those proposed exemptions, if finalized, would apply only until the respective federal agencies prescribe their own exemption rules. Furthermore, as noted above, the Concurrent Proposal includes an amendment that would exempt targeted refinances (*e.g.*, under the HARP program) from the Final Rule's repayment ability requirements. If implemented, this amendment would greatly expand the scope of refinancings eligible for exemption from the repayment ability requirements—namely, to include certain third-party refinancings.

VI. Comparison of 8 Factor Test and QM

The CFPB was thoughtful enough to publish a chart comparing the primary differences among the 8 Factor Test and QMs:

General Comparison of Ability-to-Repay Requirements with Qualified Mortgages[1]

	ATR Standard	General QM Definition	Temporary Agency/ GSE QM	Balloon-Payment QM
Loan feature limitations	No limitations	No negative amortization, interest-only, or balloon payments	No negative amortization, interest-only, or balloon payments	No negative amortization or interest-only payments
Loan term limit	No limitations	30 years	30 years	30 years
Points & fees limit	No limitations	3%	3%	3%
Payment Underwriting	Greater of fully indexed or introductory rate	Max rate in first 5 years	As applicable, per GSE or agency requirements	Amortization schedule no more than 30 years; loan term no less than 5 years
Mortgage-related obligations	Consider and verify	Included in underwriting monthly payment[2] and DTI[3]	As applicable, per GSE or agency requirements	Consider and verify
Income or assets	Consider and verify	Consider and verify	As applicable, per GSE or agency requirements	Consider and verify
Employment status	Consider and verify	Included in underwriting DTI	As applicable, per GSE or agency requirements	No specific requirement
Simultaneous loans	Consider and verify	Included in underwriting DTI	As applicable, per GSE or agency requirements	No specific requirement
Debt, alimony, child support	Consider and verify	Consider and verify	As applicable, per GSE or agency requirements	Consider and verify
DTI or Residual Income	Consider and verify	DTI ≤ 43 percent	As applicable, per GSE or agency requirements	Consider and verify
Credit History	Consider and verify	Included in underwriting DTI	As applicable, per GSE or agency requirements	No specific requirement

1 This chart compares the general ATR requirements with the requirements for originating QM loans. Additional requirements may apply, particularly for balloon-payment QM loans. This chart is not a substitute for the rule. Only the rule and its Official Interpretations can provide complete and definitive information regarding its requirements. The complete rule, including the Official Interpretations and small entity compliance guide, is available at http://www.consumerfinance.gov/regulations/ability-to-repay-and-qualified-mortgage-standards-under-the-truth-in-lending-act-regulation-z/.

2 "Included in underwriting monthly payment" means that the rule does not require the creditor to separately consider and verify this factor. However, a creditor must consider and verify this factor when underwriting the consumer's monthly payment under the rule.

3 "Included in underwriting DTI" means that the rule does not require the creditor to separately consider and verify these factors. However, a creditor considers and verifies these factors when determining whether the consumer's debt-to-income ratio meets the 43 percent debt-to-income threshold.

VII. Liability and Penalties

There is significant potential liability for violating the Final Rule.

Unless the failure to comply is not material, an aggrieved borrower may bring an affirmative action for actual damages, statutory damages (individual and class actions), costs and attorney fees, and special damages equal to all finance charges and fees. An affirmative action is subject to a three-year statute of limitations. However, a borrower may also assert a recoupment or setoff claim as a defense against the creditor or an assignee in a foreclosure or enforcement action. There is no statute of limitations that attaches to this right, but the special statutory damages are limited to no more than three years of finance charges and fees. Further, the longer the borrower has been paying as agreed, the less likely a court will be to find that the creditor's original underwriting determination was materially flawed – thus, if only as a practical matter, it may be difficult for a borrower to assert a defensive claim long after the origination of the loan.

In addition to the TILA damages, the CFPB has authority to issue cease and desist orders and impose civil monetary penalties. For any person that violates, through any act or omission, any provision of a federal consumer financial law such as TILA, the CFPB may assess a civil penalty:

- in the amount of $5,000 per day for a violation,
- up to $25,000 per day for any reckless violation, and
- up to $1 million per day for any knowing violation.

The factors the CFPB will consider in determining which penalty to apply include: (a) size of financial resources and good faith of the person charged; (b) gravity of the violation; (c) severity of the risks to, or losses of, the consumer; and (d) history of previous violations.

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[1] The Rule was published in the Federal Register on January 30, 2013 at https://www.federalregister.gov/articles/2013/01/30/2013-00736/ability-to-repay-and-qualified-mortgage-standards-under-the-truth-in-lending-act-regulation-z. In addition to the Final Rule, the CFPB adopted a tsunami of final rules relating to mortgage credit, including requirements for mortgage appraisals, escrows, high cost mortgages, servicing, and loan originator compensation. K&L Gates issued a Client Alert on the loan originator compensation regulations CFPB Solidifies Loan Originator Compensation Restrictions, Dumps Zero-Zero Requirement and intends to issue other Client Alerts relating to these CFPB issuances.

[2] Proposed Amendments to the Ability to Repay Standards under the Truth in Lending Act (Regulation Z) (Jan. 10, 2013), available at http://files.consumerfinance.gov/f/201301_cfpb_concurrent-proposal_ability-to-repay.pdf.

[3] See 78 Fed. Reg. 6408, 6583 (Jan. 30, 2013) (12 C.F.R. § 1026.43(c)).

[4] See id. at 6408, 6419.

[5] See id. at 6446; see also 15 U.S.C. § 1602(cc)(5). Two TILA subsections designated 103(cc) exist due to a discrepancy in the instructions given by the Dodd-Frank Act. See Dodd-Frank Act sections 1100A and 1401.

[6] See 78 Fed. Reg. 6408, 6584 (Jan. 30, 2013) (12 C.F.R. § 1026.43(a)).

[7] See id. at 6584 (Official Staff Interpretation to 12 C.F.R. § 1026.43(a)).

[8] Id. at 6518.

[9] Id. at 6447, 6581; see also 12 C.F.R. § 1026.3(a).

[10] See id. at 6484, 6586 (12 C.F.R. § 1026.43(b)(4), and 12 C.F.R. § 1026.43(e)(1)(i) and (ii)).

[11] See id. at 6585 (12 C.F.R. § 1026.43(c)).

[12] See id. at 6460-61 ("The Bureau believes that a variety of underwriting standards can yield reasonable, good faith ability-to-repay determinations."); see also Official Staff Interpretation to 12 C.F.R. § 1026.43(c)(1)-1 ("So long as creditors consider the factors set forth in § 1026.43(c)(2) according to the requirements of § 1026.43(c), 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.”).

[13] See id. at 6464 (Official Staff Interpretation to 12 C.F.R. § 1026.43(c)(2)(i)-1.).

[14] Id.

[15] See id. at 6604. (Official Staff Interpretation to 12 C.F.R. § 226.43(c)(2)(i)).

[16] See id. at 6585 (12 C.F.R. § 1026.43(c)(2)(ii)).

[17] See id. at 6604 (Official Staff Interpretation to 12 C.F.R. § 1026.43(c)(2)(i)-(3)).

[18] See 78 Fed. Reg. 6408, 6585 (Official Staff Interpretation to 12 C.F.R. § 1026.43(c)(2)(i)-(1)).

[19] See id. at 6465 (Official Staff Interpretation to 12 C.F.R. § 1026.43(c)(2)(ii)).

[20] Id.; see also Official Staff Interpretation to 12 C.F.R. § 1026.43(c)(2)(ii)-(1) (“For example, if a creditor relies wholly on a consumer’s investment income to determine repayment ability, the creditor need not verify or document employment status.”).

[21] See 78 Fed. Reg. 6408, 6585 (12 C.F.R. § 1026.43(c)(2)(iv)).

[22] See id. at 6605 (Official Staff Interpretation to 12 C.F.R. § 1026.43(c)(5)(i)).

[23] See id. at 6585 (12 C.F.R. § 1026.43(c)(5)).

[24] See id. at 6585 (12 C.F.R. § 1026.43(c)(2)(iv)).

[25] See id. at 6605 (Official Staff Interpretation to 12 C.F.R. § 1026.43(c)(2)(iv).).

[26] See id. at 6467 (Official Staff Interpretation to 12 C.F.R. § 1026.43(c)(2)(v)).

[27] Id.

[28] See id. at 6585; see also Official Staff Interpretation to 12 C.F.R. § 1026.43(c)(2)(vi)-(1) (“Section 1026.43(c)(2)(vi) requires creditors to consider a consumer’s current debt obligations and any alimony or child support the consumer is required to pay. Examples of current debt obligations include student loans, automobile loans, revolving debt, and existing mortgages that will not be paid off at or before consummation. Creditors 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.”).

[29] See id. at 6585.

[30] Id.

[31] 78 Fed. Reg. 6408, 6585 (Official Staff Interpretation to 12 C.F.R. § 1026.43(c)(7)).

[32] Id.

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[33] See id. at 6585 (Official Staff Interpretation to 12 C.F.R. § 1026.43(c)(7)(1) ("In contrast to the qualified mortgage provisions in § 1026.43(e), § 1026.43(c) does not prescribe a specific monthly debt-to-income ratio with which creditors must comply. Instead, an appropriate threshold for a consumer's monthly debt-to-income 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.").).

[34] Id.

[35] See id. at 6585 (Official Staff Interpretation to 12 C.F.R. § 1026.43(c)(2)(viii) ("Section 1026.43(c)(2)(viii) does not require creditors to obtain or consider a consolidated credit score or prescribe a minimum credit score that creditors must apply. The rule 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. Some aspects of a consumer's credit history, whether positive or negative, may not be directly indicative of the consumer's ability to repay. A creditor therefore 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.")).

[36] See 12 C.F.R. § 1026.43(b)(4).

[37] See 78 Fed. Reg. 6408, 6512 (Jan. 30, 2013).

[38] See id. at 6513.

[39] See id. § 1639c(b)(2)(A)(viii).

[40] See 76 Fed. Reg. 6408, 6518 (Jan. 30, 2013).

[41] The Final Rule establishes a five-tier structure, presented in the table below, in which mortgages of certain loan amounts retain the designation of a QM as long as their total points and fees do not exceed the listed thresholds. See 78 Fed. Reg. 6531. All listed fixed dollar amounts will be inflation-indexed on an annual basis, and the adjusted values will be published as a regulatory comment. See 78 Fed. Reg. 6533 (indicating that the inflation index will be the CPI-U and that the adjusted limits will be published as a comment to 12 C.F.R. § 1026.43(e)(3)(ii)).

Loan Amount	**Points and Fees Threshold**
Greater than $100,000	3% of the total loan amount
Greater than or equal to $60,000, but less than $100,000	$3,000
Greater than or equal to $20,000, but less than $60,000	5% of the total loan amount
Greater than or equal to $12,500, but less than $20,000	$1,000
Less than $12,500	8% of the total loan amount

[42] See 12 C.F.R. § 1026.43(e)(2)(iv).

[43] See id. § 1026.43(c)(5)(i)(A).

[44] See 78 Fed. Reg. 6408, 6506 (Jan. 30, 2013).

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[45] The CFPB has adopted a definition of points and fees for the purposes of its QM rule that generally is the same as the definition for the purposes of determining when a loan is a high-cost mortgage under HOEPA. See 78 Fed. Reg. 6423.

[46] See id. at 6435.

[47] See, e.g., 78 Fed. Reg. 6428 (indicating that the "more specific provision on private mortgage insurance supersedes the more general provision permitting any bona fide third party charge not retained by the creditor, mortgage originator, or an affiliate of either to be excluded from 'points and fees'"); 78 Fed. Reg. 6430 (indicating that "the more specific provision governing the inclusion in points and fees of real estate related charges . . . [takes] precedence over the more general exclusion for bona fide third party charges[.]").

[48] See 78 Fed. Reg. 6571.

[49] See 78 Fed. Reg. 6424.

[50] *See id.* For the most part, "known at or before consummation" means both that the value of the charge is known and that the fact that the charge will be made is known. Servicing related fees, such as potential modification fees, are excluded because the lender does not know, at or before consummation, whether the loan will ever be modified. One significant exception to this rule is the treatment of prepayment penalties for the loan being originated, which are included as "points and fees" at the maximum value under the loan contract, despite the fact that they may never be charged. *See* 78 Fed. Reg. 6424-25.

[51] *See* 78 Fed. Reg. 6424.

[52] *See* 78 Fed. Reg. 6435.

[53] *See* 78 Fed. Reg. 6583 (indicating the new contents of 12 C.F.R. § 1026.32(b)(1), the definition of "points and fees" for high-cost loans, which is then made applicable to qualified mortgages through 12 C.F.R. § 1026.43(e)(3))

[54] *See* 78 Fed. Reg. 6583-84 (12 C.F.R. § 1026.32(b)(1)(ii)).

[55] *See* 12 C.F.R. § 1026.36(a)(1).

[56] *See* 78 Fed. Reg. 6433.

[57] *See id.*

[58] *See* 78 Fed. Reg. 6598 (interpretive comment 2 to 12 C.F.R. § 1026.32(b)(1)(ii)).

[59] *See* 78 Fed. Reg. 6435.

[60] *See* 78 Fed. Reg. 6436.

[61] *See* 78 Fed. Reg. 6437.

[62] *See* 78 Fed. Reg. 6438.

[63] *See id.*

[64] *See* 78 Fed. Reg. 6584 (12 C.F.R. § 1026.32(b)(1)(iii)). The relevant real estate related fees include: (a) title fees; (b) document preparation fees; (c) notary and credit-report fees; (d) appraisal and inspection fees; and (e) amounts payable to escrow or trustee accounts not otherwise included in the finance charge. *See* 12 C.F.R. § 1026.4(c)(7).

[65] *See* 78 Fed. Reg. 6439.

[66] *See* 78 Fed. Reg. 6584 (12 C.F.R. § 1026.32(b)(1)(iv) (emphasis added)).

[67] *See id.* (12 C.F.R. § 1026.32(b)(1)(v)).

[68] *See id.* (12 C.F.R. § 1026.32(b)(1)(vi)).

[69] *See id.* (12 C.F.R. § 1026.32(b)(6)). Note that FHA's treatment of a borrower who pays off a mortgage in the middle of a month, which currently results in a prepayment penalty of the difference between the monthly interest amount and the interest accrued through the date of prepayment, is exempted from the definition of a "prepayment penalty" until January 21, 2015. *See id.* The Bureau has provided this extended compliance period to allow FHA time to change its relevant requirements. *See* 78 Fed. Reg. 6571 n. 232.

[70] *See* 78 Fed. Reg. 6583 (12 C.F.R. § 1026.32(b)(1)(i)(B)).

[71] *See id.* (12 C.F.R. § 1026.32(b)(1)(i)(C)(1)).

[72] Under section 203(c)(2)(A) of the National Housing Act, 12 U.S.C. 1709(c)(2)(A).

[73] *See id.* (12 C.F.R. § 1026.32(b)(1)(i)(C)(2)).

[74] *See* 78 Fed. Reg. 6427.

[75] *See* 78 Fed. Reg. 6427-28.

[76] *See* 78 Fed. Reg. 6428.

[77] See id. at 6428.

[78] *See id.*

[79] *See* 78 Fed. Reg. 6431.

[80] *See* 78 Fed. Reg. 6583 (12 C.F.R. § 1026.32(b)(1)(i)(E)).

[81] *See id.* (12 C.F.R. § 1026.32(b)(1)(i)(F)). For the purposes of determining whether a personal property loan is a high cost loan, however, the relevant interest rate index is the "average rate for a loan insured under Title I of the National Housing Act." *See id.* (12 C.F.R. §§ 1026.32(b)(1)(i)(E)-(F)).

[82] *See* 78 Fed. Reg. 6441-42.

[83] See 12 C.F.R. § 1026.43(e)(4).

[84] See 15 U.S.C. § 1639c(b)(3)(B)(ii).

[85] See 12 C.F.R. § 1026.43(e)(4).

[86] See 78 Fed. Reg. 6408, 6534 (Jan. 30, 2013).

[87] See Comment 43(e)(4)-4.

[88] See Fannie Mae Single Family 2013 Selling Guide, Ch. B2-3-01.

[89] See HUD Handbook 4155.1 4.B.4.e.

[90] See 78 Fed. Reg. 6622, 6668 (Jan. 30, 2013).

[91] See 15 U.S.C. § 1639c(b)(2)(E).

[92] See 12 C.F.R. § 1026.43(f).

[93] Additionally, the transfer, sale or assignment of a balloon payment qualified mortgage will not cause the mortgage to lose its qualified mortgage status if: (1) the balloon-payment qualified mortgage is sold, assigned, or transferred to another person pursuant to a capital restoration plan or other action under 12 U.S.C. § 1831o, actions or instructions of any person acting as conservator, receiver, or bankruptcy trustee, an order of State of Federal governmental agency with jurisdiction to examine the creditor pursuant to State or Federal law, or an agreement between the creditor and such an agency; or (2) the balloon-payment qualified mortgage is sold, assigned, or otherwise transferred pursuant to a merger of the creditor with

another person or acquisition of the creditor by another person or of another person by the creditor. See 12 C.F.R. § 1026.43(f)(2).

[94] See 78 Fed. Reg. 6622, 6655 (Jan. 30, 2013).

[95] See id. at 6655.

[96] See id. at 6496.

[97] See 12 C.F.R. § 1026.43(d).

[98] See 78 Fed. Reg. 6408, 6495 (Jan. 30, 2013).

[99] "Recast" means: (1) For an adjustable-rate mortgage, as defined in 12 C.F.R. § 1026.18(s)(7)(i), the expiration of the period during which payments based on the introductory fixed rate are permitted under the terms of the legal obligation: (2) for an interest-only loan, as defined in 12 C.F.R. § 1026.18(s)(7)(iv), the expiration of the period during which interest-only payments are permitted under the terms of the legal obligation; and (3) for a negative amortization loan, as defined in 12 C.F.R. § 1026.18(s)(7)(v), the expiration of the period during which negatively amortizing payments are permitted under the terms of the legal obligation. See 12 C.F.R. § 1026.43(b)(11).

[100] See 78 Fed. Reg. 6622, 6623 (Jan 30. 2013).

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K&L Gates' Consumer Financial Services practice provides a comprehensive range of transactional, regulatory compliance, enforcement and litigation services to the lending and settlement service industry. Our focus includes first- and subordinate-lien, open- and closed-end residential mortgage loans, as well as multi-family and commercial mortgage loans. We also advise clients on direct and indirect automobile, and manufactured housing finance relationships. In addition, we handle unsecured consumer and commercial lending. In all areas, our practice includes traditional and e-commerce applications of current law governing the fields of mortgage banking and consumer finance.

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