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Part II

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12 CFR Part 226

Regulation Z; Truth in Lending; Proposed Rule

FEDERAL RESERVE SYSTEM

12 CFR Part 226

[Regulation Z; Docket No. R–1417]

RIN 7100–AD75

Regulation Z; Truth in Lending

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Proposed rule; request for public comment.

SUMMARY: The Board is publishing for public comment a proposed rule amending Regulation Z (Truth in Lending) to implement amendments to the Truth in Lending Act (TILA) made by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act or Act). Regulation Z currently prohibits a creditor from making a higher-priced mortgage loan without regard to the consumer's ability to repay the loan. The proposal would implement statutory changes made by the Dodd-Frank Act that expand the scope of the ability-to-repay requirement to cover any consumer credit transaction secured by a dwelling (excluding an open-end credit plan, timeshare plan, reverse mortgage, or temporary loan). In addition, the proposal would establish standards for complying with the ability-to-repay requirement, including by making a "qualified mortgage." The proposal also implements the Act's limits on prepayment penalties. Finally, the proposal would require creditors to retain evidence of compliance with this rule for three years after a loan is consummated. General rulemaking authority for TILA is scheduled to transfer to the Consumer Financial Protection Bureau (CFPB) on July 21, 2011. Accordingly, this rulemaking will become a proposal of the CFPB and will not be finalized by the Board.

DATES: Comments on this proposed rule must be received on or before July 22, 2011. All comment letters will be transferred to the Consumer Financial Protection Bureau.

ADDRESSES: You may submit comments, identified by Docket No. R–1417 and RIN No. 7100–AD75, by any of the following methods:

- *Agency Web Site: http://www.federalreserve.gov.* Follow the instructions for submitting comments at *http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm.*
- *Federal eRulemaking Portal: http://www.regulations.gov.* Follow the instructions for submitting comments.
- *E-mail: regs.comments@federalreserve.gov.* Include the docket number in the subject line of the message.
- *Fax:* (202) 452–3819 or (202) 452–3102.
- *Mail:* Address to Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551.

All public comments will be made available on the Board's Web site at *http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm* as submitted, unless modified for technical reasons. Accordingly, comments will not be edited to remove any identifying or contact information. Public comments may also be viewed electronically or in paper in Room MP–500 of the Board's Martin Building (20th and C Streets, NW.) between 9 a.m. and 5 p.m. on weekdays.

FOR FURTHER INFORMATION CONTACT: Jamie Z. Goodson, Catherine Henderson, or Priscilla Walton-Fein, Attorneys; Paul Mondor, Lorna Neill, Nikita M. Pastor, or Maureen C. Yap, Senior Attorneys; or Brent Lattin, Counsel; Division of Consumer and Community Affairs, Board of Governors of the Federal Reserve System, Washington, DC 20551, at (202) 452–2412 or (202) 452–3667. For users of Telecommunications Device for the Deaf (TDD) only, contact (202) 263–4869.

SUPPLEMENTARY INFORMATION:

I. Summary of the Proposed Rule

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act or Act) amends the Truth in Lending Act (TILA) to prohibit creditors from making mortgage loans without regard to the consumer's repayment ability. Public Law 111–203 § 1411, 124 Stat. 1376, 2142 (to be codified at 15 U.S.C. 1639c). The Act's underwriting requirements are substantially similar but not identical to the ability-to-repay requirements adopted by the Board for higher-priced mortgage loans in July 2008 under the Home Ownership and Equity Protection Act. 73 FR 44522, Jul. 30, 2008 ("2008 HOEPA Final Rule"). General rulemaking authority for TILA is scheduled to transfer to the Consumer Financial Protection Bureau (CFPB) in July 2011. Accordingly, this rulemaking will become a proposal of the CFPB and will not be finalized by the Board.

Consistent with the Act, the proposal applies the ability-to-repay requirements to any consumer credit transaction secured by a dwelling, except an open-end credit plan, timeshare plan, reverse mortgage, or temporary loan. Thus, unlike the Board's 2008 HOEPA Final Rule, the proposal is not limited to higher-priced mortgage loans or loans secured by the consumer's principal dwelling. The Act prohibits a creditor from making a mortgage loan unless the creditor makes a reasonable and good faith determination, based on verified and documented information, that the consumer will have a reasonable ability to repay the loan, including any mortgage-related obligations (such as property taxes).

Consistent with the Act, the proposal provides four options for complying with the ability-to-repay requirement. First, a creditor can meet the general ability-to-repay standard by originating a mortgage loan for which:

- The creditor considers and verifies the following eight underwriting factors in determining repayment ability: (1) Current or reasonably expected income or assets; (2) current employment status; (3) the monthly payment on the mortgage; (4) the monthly payment on any simultaneous loan; (5) the monthly payment for mortgage-related obligations; (6) current debt obligations; (7) the monthly debt-to-income ratio, or residual income; and (8) credit history; and
- The mortgage payment calculation is based on the fully indexed rate.

Second, a creditor can refinance a "non-standard mortgage" into a "standard mortgage." This is based on a statutory provision that is meant to provide flexibility for streamlined refinancings, which are no- or low-documentation transactions designed to quickly refinance a consumer out of a risky mortgage into a more stable product. Under this option, the creditor does not have to verify the consumer's income or assets. The proposal defines a "standard mortgage" as a mortgage loan that, among other things, does not contain negative amortization, interest-only payments, or balloon payments; and has limited points and fees.

Third, a creditor can originate a "qualified mortgage," which provides special protection from liability for creditors who make "qualified mortgages." It is unclear whether that protection is intended to be a safe harbor or a rebuttable presumption of compliance with the repayment ability requirement. Therefore, the Board is proposing two alternative definitions of a "qualified mortgage."

Alternative 1 operates as a legal safe harbor and defines a "qualified mortgage" as a mortgage for which:

(a) The loan does not contain negative amortization, interest-only payments, or balloon payments, or a loan term exceeding 30 years;

(b) The total points and fees do not exceed 3% of the total loan amount;

(c) The borrower's income or assets are verified and documented; and

(d) The underwriting of the mortgage (1) is based on the maximum interest rate in the first five years, (2) uses a payment schedule that fully amortizes the loan over the loan term, and (3) takes into account any mortgage-related obligations.

Alternative 2 provides a rebuttable presumption of compliance and defines a "qualified mortgage" as including the criteria listed under Alternative 1 as well as the following additional underwriting requirements from the ability-to-repay standard: (1) The consumer's employment status, (2) the monthly payment for any simultaneous loan, (3) the consumer's current debt obligations, (4) the total debt-to-income ratio or residual income, and (5) the consumer's credit history.

Finally, a small creditor operating predominantly in rural or underserved areas can originate a balloon-payment qualified mortgage. This standard is evidently meant to accommodate community banks that originate balloon loans to hedge against interest rate risk. Under this option, a small creditor can make a balloon-payment qualified mortgage if the loan term is five years or more, and the payment calculation is based on the scheduled periodic payments, excluding the balloon payment.

The proposal also implements the Dodd-Frank Act's limits on prepayment penalties, lengthens the time creditors must retain records that evidence compliance with the ability-to-repay and prepayment penalty provisions, and prohibits evasion of the rule by structuring a closed-end extension of credit as an open-end plan. The Dodd-Frank Act contains other consumer protections for mortgages, which will be implemented in subsequent rulemakings.

II. Background

Over the years, concerns have been raised about creditors originating mortgage loans without regard to the consumer's ability to repay the loan. Beginning in about 2006, these concerns were heightened as mortgage delinquencies and foreclosures rates increased dramatically, caused in part by the loosening of underwriting standards. *See* 73 FR 44524, Jul. 30, 2008. Following is background information, including a brief summary of the legislative and regulatory responses to this issue, which culminated in the enactment of the Dodd-Frank Act on July 21, 2010.

A. TILA and Regulation Z

In 1968, Congress enacted TILA, 15 U.S.C. 1601 *et seq.,* based on findings that economic stability would be enhanced and competition among consumer credit providers would be strengthened by the informed use of credit resulting from consumers' awareness of the cost of credit. One of the purposes of TILA is to promote the informed use of consumer credit by requiring disclosures about its costs and terms. TILA requires additional disclosures for loans secured by consumers' homes and permits consumers to rescind certain transactions that involve their principal dwelling. TILA directs the Board to prescribe regulations to carry out the purposes of the law, and specifically authorizes the Board, among other things, to issue regulations that contain such additional requirements, classifications, differentiations, or other provisions, or that provide for such adjustments and exceptions for all or any class of transactions, that in the Board's judgment are necessary or proper to effectuate the purposes of TILA, facilitate compliance with TILA, or prevent circumvention or evasion. 15 U.S.C. 1604(a). TILA is implemented by the Board's Regulation Z, 12 CFR part 226. An Official Staff Commentary interprets the requirements of the regulation and provides guidance to creditors in applying the rules to specific transactions. *See* 12 CFR part 226, Supp. I.

B. The Home Ownership and Equity Protection Act (HOEPA) and HOEPA Rules

In response to evidence of abusive practices in the home-equity lending market, Congress amended TILA by enacting the Home Ownership and Equity Protection Act (HOEPA) in 1994. Public Law 103–325, 108 Stat. 2160. HOEPA defines a class of "high-cost mortgages," which are generally closed-end home-equity loans (excluding home-purchase loans) with annual percentage rates (APRs) or total points and fees exceeding prescribed thresholds.[1] HOEPA created special substantive protections for high-cost mortgages, including prohibiting a creditor from engaging in a pattern or practice of extending a high-cost mortgage to a consumer based on the consumer's collateral without regard to the consumer's repayment ability, including the consumer's current and expected income, current obligations, and employment. TILA Section 129(h); 15 U.S.C. 1639(h). In addition to the disclosures and limitations specified in the statute, TILA Section 129, as added by HOEPA, expanded the Board's rulemaking authority. TILA Section 129(*l*)(2)(A) authorizes the Board to prohibit acts or practices the Board finds to be unfair and deceptive in connection with mortgage loans. 15 U.S.C. 1639(*l*)(2)(A). TILA Section 129(*l*)(2)(B) authorizes the Board to prohibit acts or practices in connection with the refinancing of mortgage loans that the board finds to be associated with abusive lending practices, or that are otherwise not in the interest of the borrower. 15 U.S.C. 1639(*l*)(2)(B).

In addition, HOEPA created three special remedies for a violation of its provisions. First, a consumer who brings a timely action against a creditor for a violation of rules issued under TILA Section 129 may be able to recover special statutory damages equal to the sum of all finance charges and fees paid by the consumer (often referred to as "HOEPA damages"), unless the creditor demonstrates that the failure to comply is not material. TILA Section 130(a); 15 U.S.C. 1640(a). This recovery is in addition to actual damages; statutory damages in an individual action or class action, up to a prescribed threshold; and court costs and attorney fees that would be available for violations of other TILA provisions. Second, if a creditor assigns a high-cost mortgage to another person, the consumer may be able to obtain from the assignee all of the foregoing damages. TILA Section 131(d); 15 U.S.C. 1641(d). For all other loans, TILA Section 131(e), 15 U.S.C. 1641(e), limits the liability of assignees for violations of Regulation Z to disclosure violations that are apparent on the face of the disclosure statement required by TILA. Finally, a consumer has a right to rescind a transaction for up to three years after consummation when the mortgage contains a provision prohibited by a rule adopted under the authority of TILA Section 129(*l*)(2). TILA Section 125 and 129(j); 15 U.S.C. 1635 and 1639(j). Any consumer who has the right to rescind a transaction may rescind the transaction as against any assignee. TILA Section 131(c); 15 U.S.C. 1641(c). The right of rescission does not extend, however, to home purchase loans, construction loans, or certain refinancings with the same

[1] Mortgages covered by the HOEPA amendments have been referred to as "HOEPA loans," "Section 32 loans," or "high-cost mortgages." The Dodd-Frank Act now refers to these loans as "high-cost mortgages." *See* the Dodd-Frank Act § 1431; TILA Section 103(aa). For simplicity and consistency, this proposal will use the term "high-cost mortgages" to refer to mortgages covered by the HOEPA amendments.

creditor. TILA Section 125(e); 15 U.S.C. 1635(e).

In 1995, the Board implemented the HOEPA amendments at § 226.31, 226.32, and 226.33 of Regulation Z. 60 FR 15463, March 24, 1995. In particular, § 226.32(e)(1) implemented TILA Section 129(h) to prohibit a creditor from extending a high-cost mortgage based on the consumer's collateral if, considering the consumer's current and expected income, current obligations, and employment status, the consumer would be unable to make the scheduled payments. In 2001, the Board amended these regulations to expand HOEPA's protections to more loans by revising the APR threshold, and points and fees definition. 66 FR 65604, Dec. 20, 2001. In addition, the ability-to-repay provisions in the regulation were revised to provide for a presumption of a violation of the rule if the creditor engages in a pattern or practice of making high-cost mortgages without verifying and documenting the consumers' repayment ability.

C. 2006 and 2007 Interagency Supervisory Guidance

In December 2005, the Board and the other Federal banking agencies responded to concerns about the rapid growth of nontraditional mortgages in the previous two years by proposing supervisory guidance. Nontraditional mortgages are mortgages that allow the borrower to defer repayment of principal and sometimes interest. The guidance advised institutions of the need to reduce "risk layering" practices with respect to these products, such as failing to document income or lending nearly the full appraised value of the home. The final guidance issued in September 2006 specifically advised lenders that layering risks in nontraditional mortgage loans to subprime borrowers may significantly increase risks to borrowers as well as institutions. Interagency Guidance on Nontraditional Mortgage Product Risks, 71 FR 58609, Oct. 4, 2006 ("2006 Nontraditional Mortgage Guidance").

The Board and the other Federal banking agencies addressed concerns about the subprime market in March 2007 with proposed supervisory guidance addressing the heightened risks to consumers and institutions of adjustable-rate mortgages with two- or three-year "teaser" rates followed by substantial increases in the rate and payment. The guidance, finalized in June of 2007, set out the standards institutions should follow to ensure borrowers in the subprime market obtain loans they can afford to repay. Among other steps, the guidance advised lenders to (1) use the fully-indexed rate and fully-amortizing payment when qualifying borrowers for loans with adjustable rates and potentially non-amortizing payments; (2) limit stated income and reduced documentation loans to cases where mitigating factors clearly minimize the need for full documentation of income; and (3) provide that prepayment penalty clauses expire a reasonable period before reset, typically at least 60 days. Statement on Subprime Mortgage Lending, 72 FR 37569, Jul. 10, 2007 ("2007 Subprime Mortgage Statement").[2] The Conference of State Bank Supervisors ("CSBS") and the American Association of Residential Mortgage Regulators ("AARMR") issued parallel statements for state supervisors to use with state-supervised entities, and many states adopted the statements.

D. 2008 HOEPA Final Rule

In 2006 and 2007, the Board held a series of national hearings on consumer protection issues in the mortgage market. During those hearings, consumer advocates and government officials expressed a number of concerns, and urged the Board to prohibit or restrict certain underwriting practices, such as "stated income" or "low documentation" loans, and certain product features, such as prepayment penalties. *See* 73 FR 44527, Jul. 30, 2008. The Board was also urged to adopt regulations under HOEPA, because, unlike the Interagency Supervisory Guidance, the regulations would apply to all creditors and would be enforceable by consumers through civil actions.

In response to these hearings, in July of 2008, the Board adopted final rules pursuant to the Board's authority in TILA Section 129(*l*)(2)(A). 73 FR 44522, Jul. 30, 2008 ("2008 HOEPA Final Rule"). The Board's 2008 HOEPA Final Rule defined a new class of "higher-priced mortgage loans," . Under the 2008 HOEPA Final Rule, a higher-priced mortgage loan is a consumer credit transaction secured by the consumer's principal dwelling with an APR that exceeds the average prime offer rate (APOR) for a comparable transaction, as of the date the interest rate is set, by 1.5 or more percentage points for loans secured by a first lien on the dwelling, or by 3.5 or more percentage points for loans secured by a subordinate lien on the dwelling. Section 226.35(a)(1). The definition of a "higher-priced mortgage loan" includes those loans that are defined as "high-cost mortgages."

Among other things, the Board's 2008 HOEPA Final Rule revised the ability-to-repay requirements for high-cost mortgages, and extended these requirements to higher-priced mortgage loans. Sections 226.34(a)(4), 226.35(b)(1). Specifically, the rule:

• Prohibits a creditor from extending a higher-priced mortgage loan based on the collateral and without regard to the consumer's repayment ability.

• Prohibits a creditor from relying on income or assets to assess repayment ability unless the creditor verifies such amounts using third-party documents that provide reasonably reliable evidence of the consumer's income and assets.

In addition, the Board's 2008 Final Rule provides certain restrictions on prepayment penalties for high-cost mortgages and higher-priced mortgage loans. Sections 226.32(d), 226.35(b)(2).

E. The Dodd-Frank Act

In 2007, Congress held hearings focused on rising subprime foreclosure rates and the extent to which lending practices contributed to them. *See* 73 FR 44528, Jul. 30, 2008. Consumer advocates testified that certain lending terms or practices contributed to the foreclosures, including a failure to consider the consumer's ability to repay, low- or no-documentation loans, hybrid adjustable-rate mortgages, and prepayment penalties. Industry representatives, on the other hand, testified that adopting substantive restrictions on subprime loan terms would risk reducing access to credit for some borrowers. In response to these hearings, the House of Representatives passed the Mortgage Reform and Anti-Predatory Lending Act in 2007 and 2009. H.R. 3915, 110th Cong. (2007); H.R. 1728, 111th Cong. (2009). Both bills would have amended TILA to provide consumer protections for mortgages, including ability-to-repay requirements, but neither bill was passed by the Senate.

Then, on July 21, 2010, the Dodd-Frank Act was signed into law. Public Law 111–203, 124 Stat. 1376 (2010). Title XIV of the Dodd-Frank Act contains the Mortgage Reform and Anti-Predatory Lending Act.[3] Sections 1411,

[2] The 2006 Nontraditional Mortgage Guidance and the 2007 Subprime Mortgage Statement will hereinafter collectively be referred to as the "Interagency Supervisory Guidance."

[3] Although S. Rpt. No. 111–176 generally contains the legislative history for the Dodd-Frank Act, it does not contain the legislative history for the Mortgage Reform and Anti-Predatory Lending Act. Therefore, the Board has relied on the legislative history for the 2007 and 2009 House bills for guidance in interpreting the statute. *See* H. Rpt. No. 110–441 for H.R. 3915 (2007), and H. Rpt. No. 111–194 for H.R. 1728 (2009).

1412, and 1414 of the Dodd-Frank Act create new TILA Section 129C, which, among other things, establishes new ability-to-repay requirements and new limits on prepayment penalties. Public Law 111–203, § 1411, 1412, 1414, 124 Stat. 1376, 2142–53 (to be codified at 15 U.S.C. 1639c). The Dodd-Frank Act states that Congress created new TILA Section 129C upon a finding that "economic stabilization would be enhanced by the protection, limitation, and regulation of the terms of residential mortgage credit and the practices related to such credit, while ensuring that responsible, affordable mortgage credit remains available to consumers." Dodd-Frank Act Section 1402; TILA Section 129B(a)(1). The Dodd-Frank Act further states that the purpose of TILA Section 129C is to "assure that consumers are offered and receive residential mortgage loans on terms that reasonably reflect their ability to repay the loans." Dodd-Frank Act Section 1402; TILA Section 129B(a)(2).

Specifically, TILA Section 129C:

- Expands coverage of the ability-to-repay requirements to any consumer credit transaction secured by a dwelling, except an open-end credit plan, timeshare plan, reverse mortgage, or temporary loan.
- Prohibits a creditor from making a mortgage loan unless the creditor makes a reasonable and good faith determination, based on verified and documented information, that the consumer has a reasonable ability to repay the loan according to its terms, and all applicable taxes, insurance, and assessments.
- Provides a presumption of compliance with the ability-to-repay requirements if the mortgage loan is a "qualified mortgage," which does not contain certain risky features and limits points and fees on the loan.
- Prohibits prepayment penalties unless the mortgage is a prime, fixed-rate qualified mortgage, and the amount of the prepayment penalty is limited.

The Dodd-Frank Act creates special remedies for violations of TILA Section 129C. Section 1416 of the Dodd-Frank Act provides that a consumer who brings a timely action against a creditor for a violation of TILA Section 129C(a) (the ability-to-repay requirements) may be able to recover special statutory damages equal to the sum of all finance charges and fees paid by the consumer (often referred to as "HOEPA damages"), unless the creditor demonstrates that the failure to comply is not material. TILA Section 130(a). This recovery is in addition to actual damages; statutory damages in an individual action or class action, up to a prescribed threshold; and court costs and attorney fees that would be available for violations of other TILA provisions. In addition, the statute of limitations for an action for a violation of TILA Section 129C is three years from the date of the occurrence of the violation (as compared to one year for other TILA violations). TILA Section 130(e). Moreover, Section 1413 of the Dodd-Frank Act provides that a consumer may assert a violation of TILA Section 129C(a) as a defense to foreclosure by recoupment or set off. TILA Section 130(k). There is no time limit on the use of this defense.

F. Other Recent Board Actions

In addition to the 2008 HOEPA Final Rule, the Board has recently published several proposed or final rules for mortgages that are referenced in or relevant to this proposal.

2009 Closed-End Mortgage Proposal. In August 2009, the Board issued two proposals to amend Regulation Z: One for closed-end mortgages and one for home equity lines of credit ("HELOCs"). For closed-end mortgages, the August 2009 proposal would revise the disclosure requirements to highlight potentially risky features, such as adjustable rates and negative amortization, and address other issues, such as the timing of disclosures. *See* 74 FR 43232, Aug. 26, 2009 ("2009 Closed-End Mortgage Proposal"). For HELOCs, the August 2009 proposal would revise the disclosure requirements and address other issues, such as account terminations. 74 FR 43428, Aug. 26, 2009 ("2009 HELOC Proposal"). Public comments for both proposals were due by December 24, 2009.

2010 Mortgage Proposal. In September 2010, the Board issued a proposal that would revise Regulation Z with respect to rescission, refinancing, reverse mortgages, and the refund of certain fees. *See* 75 FR 58539, Sept. 24, 2010 ("2010 Mortgage Proposal"). Public comments for this proposal were due by December 23, 2010. On February 1, 2011, the Board issued a press release stating that it does not expect to finalize the 2009 Closed-End Mortgage Proposal, 2009 HELOC Proposal, or the 2010 Mortgage Proposal prior to the transfer of authority for such rulemakings to the Consumer Financial Protection Bureau in July 2011.

2010 Loan Originator Compensation Rule. In September 2010, the Board adopted a final rule on loan originator compensation to prohibit compensation to mortgage brokers and loan officers (collectively, "loan originators") that is based on a loan's interest rate or other terms. The final rule also prohibits loan originators from steering consumers to loans that are not in the consumers' interest to increase the loan originator's compensation. 75 FR 58509, Sept. 24, 2010 ("2010 Loan Originator Compensation Rule"). This rule became effective April 6, 2011.

2010 MDIA Interim Final Rule. In May 2009, the Board adopted final rules implementing the amendments to TILA under the Mortgage Disclosure Improvement Act of 2008 ("MDIA").[4] Among other things, the MDIA and the final rules require early, transaction-specific disclosures for mortgage loans secured by a dwelling, and requires waiting periods between the time when disclosures are given and consummation of the transaction. These rules became effective July 30, 2009, as required by the statute. *See* 74 FR 23289, May 19, 2009. The MDIA also requires disclosure of payment examples if the loan's interest rate or payments can change, along with a statement that there is no guarantee that the consumer will be able to refinance the transaction in the future. Under the statute, these provisions of the MDIA became effective on January 30, 2011. On September 24, 2010, the Board published an interim rule to implement these requirements. *See* 75 FR 58470, Sept. 24, 2010. In particular, the rule provided definitions for a "balloon payment," "adjustable-rate mortgage," "step-rate mortgage," "fixed-rate mortgage," "interest-only loan," "negative amortization loan," and the "fully indexed rate." *See* § 226.18(s)(5) and (s)(7). Subsequently, the Board issued an interim rule to make certain clarifying changes. *See* 75 FR 81836, Dec. 29, 2010. The term "2010 MDIA Interim Final Rule" is used to refer to the September 2010 final rule as revised by the December 2010 final rule.

2011 Escrow Proposal and Final Rule. In March 2011, the Board issued a proposal to implement Sections 1461 and 1462 of the Dodd-Frank Act, which create new TILA Section 129D and provide certain escrow requirements for higher-priced mortgage loans. *See* 76 FR 11599, March 2, 2011 ("2011 Escrow Proposal"). In particular, the proposal would revise the definition of a "higher-priced mortgage loan," and create an exemption from the escrow requirement for any loan extended by a creditor that makes most of its first-lien higher-priced mortgage loans in counties designated by the Board as "rural or underserved," has annual originations of 100 or fewer

[4] The MDIA is contained in Sections 2501 through 2503 of the Housing and Economic Recovery Act of 2008, Public Law 110–289, enacted on July 30, 2008. The MDIA was later amended by the Emergency Economic Stabilization Act of 2008, Public Law 110–343, enacted on October 3, 2008.

first-lien mortgage loans, and does not escrow for any mortgage transaction it services.

In March 2011, the Board also issued a final rule that implements a provision of the Dodd-Frank Act that increases the APR threshold used to determine whether a mortgage lender is required to establish an escrow account for property taxes and insurance for first-lien, "jumbo" mortgage loans. *See* 76 FR 11319, March 2, 2011 ("2011 Jumbo Loan Escrow Final Rule"). Jumbo loans are loans exceeding the conforming loan-size limit for purchase by Freddie Mac, as specified by the legislation.

2011 Risk Retention Proposal. On March 31, 2011, the Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, the U.S. Department of Housing and Urban Development, and the Federal Housing Finance Agency ("Agencies") issued a proposal to implement Section 941 of the Dodd-Frank Act, which adds a new Section 15G to the Securities Exchange Act of 1934. 15 U.S.C. 78o–11. As required by the Act, the proposal generally requires the sponsor of an asset-backed security to retain not less than five percent of the credit risk of the assets collateralizing the security. The Act and the proposal include a variety of exemptions, including an exemption for an asset-backed security that is collateralized exclusively by "qualified residential mortgages." The Act requires the Agencies to define the term "qualified residential mortgage" taking into consideration underwriting and product features that historical loan performance data indicate result in a lower risk of default. The Act further provides that the definition of a "qualified residential mortgage" can be "no broader than" the definition of a "qualified mortgage" under TILA Section 129C(b)(2). The 2011 Risk Retention Proposal implements these provisions of the Act. Public comments for this proposal are due by June 10, 2011.

G. Development of This Proposal

In developing this proposal, the Board reviewed the laws, regulations, proposals, and legislative history described above as well as state ability-to-repay laws. The Board also conducted extensive outreach with consumer advocates, industry representatives, and Federal and state regulators, and examined underwriting rules and guidelines for the Federal Housing Administration, the U.S. Department of Veterans' Affairs, Fannie Mae, Freddie Mac, the Home Affordable Modification Program, and private creditors. Finally, the Board conducted independent analyses regarding the effect of various underwriting procedures and loan features on loan performance.

III. Legal Authority

TILA Section 105(a) mandates that the Board prescribe regulations to carry out the purposes of the Act. 15 U.S.C. 1604(a). In addition, TILA, as amended by the Dodd-Frank Act, specifically authorizes the Board to:

• Issue regulations that contain such additional requirements, classifications, differentiations, or other provisions, or that provide for such adjustments and exceptions for all or any class of transactions, that in the Board's judgment are necessary or proper to effectuate the purposes of TILA, facilitate compliance with the Act, or prevent circumvention or evasion. TILA Section 105(a); 15 U.S.C. 1604(a).

• By regulation, prohibit or condition terms, acts or practices relating to residential mortgage loans that the Board finds to be abusive, unfair, deceptive, or predatory; necessary or proper to ensure that responsible, affordable mortgage credit remains available to consumers in a manner consistent with the purposes of the ability-to-repay requirements; necessary or proper to effectuate the purposes of the ability-to-repay requirements, to prevent circumvention or evasion thereof, or to facilitate compliance; or are not in the interest of the borrower. TILA Section 129B(e); 15 U.S.C. 1639b(e).

• Prescribe regulations that revise, add to, or subtract from the criteria that define a qualified mortgage upon a finding that such regulations are necessary or proper to ensure that responsible, affordable mortgage credit remains available to consumers in a manner consistent with the purposes of the ability-to-repay requirements; or necessary and appropriate to effectuate the purposes of the ability-to-repay requirements, to prevent circumvention or evasion thereof, or to facilitate compliance. TILA Section 129C(b)(3)(B)(i); 15 U.S.C. 1639c(b)(3)(B)(i).

TILA, as amended by the Dodd-Frank Act, states that it is the purpose of the ability-to-repay requirements to assure that consumers are offered and receive residential mortgage loans on terms that reasonably reflect their ability to repay the loans. TILA Section 129B(a)(2); 15 U.S.C. 1639b(a)(2).

IV. Discussion of the Proposed Rule

A. Scope of Coverage

Consistent with the Dodd-Frank Act, the proposal applies to any dwelling-secured consumer credit transaction, including vacation homes and home equity loans. The proposal does not apply to open-end credit plans, timeshare plans, reverse mortgages, or temporary loans with terms of 12 months or less. The Act essentially codifies the ability-to-repay requirements of the Board's 2008 HOEPA Final Rule and expands the scope to the covered transactions described above.

B. Ability-to-Repay Requirements

Consistent with the Dodd-Frank Act, the proposal provides that a creditor may not make a covered mortgage loan unless the creditor makes a reasonable and good faith determination, based on verified and documented information, that the consumer will have a reasonable ability to repay the loan, including any mortgage-related obligations (such as property taxes). TILA Section 129C; 15 U.S.C. 1639C. The Act and the proposal provide four options for complying with the ability-to-repay requirement. Specifically, a creditor can:

• Originate a covered transaction under the general ability-to-repay standard;

• Refinance a "non-standard mortgage" into a "standard mortgage";

• Originate a "qualified mortgage," which provides a presumption of compliance with the rule; or

• Originate a balloon-payment qualified mortgage, which provides a presumption of compliance with the rule.

Each of these methods is discussed below, with a description of: (1) Limits on the loan features or term, (2) limits on points and fees, (3) underwriting requirements, and (4) payment calculations.

General Ability-to-Repay Standard

Limits on loan features, term, and points and fees. Under the general ability-to-repay standards, there are no limits on the loan's features, term, or points and fees, but the creditor must follow certain underwriting requirements and payment calculations.

Underwriting requirements. Consistent with the Dodd-Frank Act, the proposal requires the creditor to consider and verify the following eight underwriting factors:

• Current or reasonably expected income or assets;

• Current employment status;

• The monthly payment on the covered transaction;
• The monthly payment on any simultaneous loan;
• The monthly payment for mortgage-related obligations;
• Current debt obligations;
• The monthly debt-to-income ratio, or residual income; and
• Credit history.

The proposal permits the creditor to consider and verify these underwriting factors based on widely accepted underwriting standards.

The proposal is generally consistent with the Act except in one respect. The Act does not require the creditor to consider simultaneous loans that are home equity lines of credit ("HELOCs"), but the Board is using its adjustment and exception authority and discretionary regulatory authority to include HELOCs within the definition of simultaneous loans. The Board believes that such inclusion would help ensure the consumer's ability to repay the loan. Data and outreach indicated that the origination of a simultaneous HELOC markedly increases the rate of default. In addition, this approach is consistent with the Board's 2008 HOEPA Final Rule.

Payment calculations. Under the general ability-to-repay standard, the Dodd-Frank Act does not ban mortgage features, but instead requires the creditor to underwrite the mortgage payment according to certain assumptions and calculations. Specifically, consistent with the Act, the proposal requires creditors to calculate the mortgage payment using: (1) The fully indexed rate; and (2) monthly, substantially equal payments that amortize the loan amount over the loan term. In addition, the Board is using its adjustment and exception authority and discretionary regulatory authority to require the creditor to underwrite the payment based on the introductory interest rate if it is greater than the fully indexed rate. Some transactions use a premium initial rate that is higher than the fully indexed rate. The Board believes this approach would help ensure the consumer's ability to repay the loan and prevent circumvention or evasion.

The Act and proposal also provide special payment calculations for interest-only loans, negative amortization loans, and balloon loans. In particular, the requirements for balloon loans depend on whether the loan is "higher-priced" [5] or not. Consistent with the Act, the proposal requires a creditor to underwrite a higher-priced loan with a balloon payment by considering the consumer's ability to make the balloon payment (without refinancing). As a practical matter, this would mean that a creditor would not be able to make a higher-priced balloon loan unless the consumer had substantial documented assets or income.

The Act permits a creditor to underwrite a balloon loan that is not higher-priced in accordance with regulations prescribed by the Board. The proposal requires creditors to underwrite a balloon loan using the maximum payment scheduled during the first five years after consummation. This approach would not capture the balloon payment for a balloon loan with a term of five years or more. The Board believes five years is the appropriate time horizon in order to ensure consumers have a reasonable ability to repay the loan, and to preserve credit choice and availability. Moreover, the five year time horizon is consistent with other provisions in the Act and the proposal, which require underwriting based on the first five years after consummation (for qualified mortgages and the refinancing of a non-standard mortgage) or which require a minimum term of five years (for balloon-payment qualified mortgages made by certain creditors).

Refinancing of a Non-Standard Mortgage

The Dodd-Frank Act provides an exception to the ability-to-repay standard's underwriting requirements if: (1) The same creditor is refinancing a "hybrid mortgage" into a "standard mortgage," (2) the consumer's monthly payment is reduced through the refinancing, and (3) the consumer has not been delinquent on any payment on the existing hybrid mortgage. This provision appears to be intended to provide flexibility for streamlined refinancings, which are no- or low-documentation loans designed to quickly refinance a consumer in a risky mortgage into a more stable product. Streamlined refinancings have substantially increased in recent years to accommodate consumers at risk of default.

Definitions—loan features, term, and points and fees. Although the Act uses the term "hybrid mortgage," the proposal uses the term "non-standard mortgage," defined as (1) an adjustable-rate mortgage with an introductory fixed interest rate for a period of years, (2) an interest-only loan, and (3) a negative amortization loan. The Board believes that this definition is consistent with the legislative history, which indicates that Congress was generally concerned with loans that provide for "payment shock" through significantly higher payments over the life of the loan.

The proposal defines the term "standard mortgage" as a covered transaction which, among other things, does not contain negative amortization, interest-only payments, or balloon payments; and limits the points and fees.

Underwriting requirements. If the conditions described above are met, the Act states that the creditor may give concerns about preventing a likely default a "higher priority as an acceptable underwriting practice." The Board interprets this provision to provide an exception from the general ability-to-repay requirements for income and asset verification. The Board believes that this approach is consistent with the statute and would preserve access to streamlined refinancings.

Payment calculations. The proposal provides specific payment calculations for purposes of determining whether the refinancing reduces the consumer's monthly mortgage payment, and for determining whether the consumer has the ability to repay the standard mortgage. The calculation for the non-standard mortgage would reflect the highest payment that would occur as of the date of the expiration of the period during which introductory-rate payments, interest-only payments, or negatively amortizing payments are permitted. For a standard mortgage, the calculation would be based on: (1) The maximum interest rate that may apply during the first five years after consummation, and (2) monthly, substantially equal payments that amortize the loan amount over the loan term.

Safe Harbor or Presumption of Compliance for a Qualified Mortgage

Under the Board's 2008 HOEPA Final Rule, a creditor may obtain a presumption of compliance with the repayment ability requirement if it follows the required procedures, such as verifying the consumer's income or assets, and additional optional procedures, such as assessing the consumer's debt-to-income ratio. However, the 2008 HOEPA Final Rule makes clear that even if the creditor follows the required and optional criteria, the creditor has only obtained a *presumption* of compliance with the repayment ability requirement. The consumer can still rebut or overcome

[5] The Act provides separate underwriting requirements for balloon loans depending on whether the loan's APR exceeds the APOR by 1.5 percent for a first-lien loan or by 3.5 percent for a subordinate-lien loan.

that presumption by showing that, despite following the required and optional procedures, the creditor nonetheless disregarded the consumer's ability to repay the loan. For example, the consumer could present evidence that although the creditor assessed the consumer's debt-to-income ratio, that ratio was very high with little residual income. This evidence may be sufficient to overcome the presumption of compliance and demonstrate that the creditor extended credit without regard to the consumer's ability to repay the loan.

The Dodd-Frank Act provides special protection from liability for creditors who make "qualified mortgages," but it is unclear whether that protection is intended to be a safe harbor or a rebuttable presumption of compliance with the repayment ability requirement. The Act states that a creditor or assignee "may presume" that a loan has met the repayment ability requirement if the loan is a "qualified mortgage." This might suggest that originating a qualified mortgage only provides a presumption of compliance, which the consumer can rebut by providing evidence that the creditor did not, in fact, make a good faith and reasonable determination of the consumer's ability to repay the loan.

However, the Act does not state that a creditor that makes a "qualified mortgage" must comply with all of the underwriting criteria of the general ability-to-repay standard. Specifically, the Act defines a "qualified mortgage" as a covered transaction for which:

- The loan does not contain negative amortization, interest-only payments, or balloon payments;
- The term does not exceed 30 years;
- The points and fees generally do not exceed three percent of the total loan amount;
- The income or assets are considered and verified;
- The total debt-to-income ratio or residual income complies with any guideline or regulation prescribed by the Board; and
- The underwriting: (1) Is based on the maximum rate during the first five years, (2) uses a payment schedule that fully amortizes the loan over the loan term, and (3) takes into account all mortgage-related obligations.

The definition of a "qualified mortgage" does not require the creditor to consider and verify the following underwriting requirements that are part of the general ability-to-repay standard: (1) The consumer's employment status, (2) the payment of any simultaneous loans of which the creditor knows or has reason to know, (3) the consumer's current obligations, and (4) the consumer's credit history. Thus, if the "qualified mortgage" definition is deemed to be a safe harbor, the consumer could not allege the creditor violated the repayment ability requirement by failing to consider and verify employment status, simultaneous loans, current obligations, or credit history. Under this approach, originating a "qualified mortgage" would be an alternative to complying with the general ability-to-repay standard and would operate as a safe harbor. Thus, if a creditor satisfied the qualified mortgage criteria, the consumer could not assert that the creditor had violated the ability-to-repay provisions. The consumer could only show that the creditor did not comply with one of the qualified mortgage safe harbor criteria.

There are sound policy reasons for interpreting a "qualified mortgage" as providing either a safe harbor or a presumption of compliance. Interpreting a "qualified mortgage" as a safe harbor would provide creditors with an incentive to make qualified mortgages. That is, in exchange for limiting loan fees and features, the creditor's regulatory burden and exposure to liability would be reduced. Consumers may benefit by being provided with mortgage loans that do not have certain risky features or high costs. However, the drawback to this approach is that a creditor could not be challenged for failing to underwrite a loan based on the consumer's employment status, simultaneous loans, current debt obligations, or credit history, or for generally not making a reasonable and good faith determination of the consumer's ability to repay the loan.

Interpreting a "qualified mortgage" as providing a rebuttable presumption of compliance would better ensure that creditors consider a consumer's ability to repay the loan. Creditors would have to make individualized determinations that the consumer had the ability to repay the loan based on all of the underwriting factors listed in the general ability-to-repay standard. This approach would require the creditor to comply with all of the ability-to-repay standards, and preserve the consumer's ability to use these standards in a defense to foreclosure or other legal action. In addition, a consumer could assert that, despite complying with the criteria for a qualified mortgage and the ability-to-repay standard, the creditor did not make a reasonable and good faith determination of the consumer's ability to repay the loan. However, the drawback of this approach is that it provides little legal certainty for the creditor, and thus, little incentive to make a "qualified mortgage," which limits loan fees and features.

Because of the statutory ambiguity and these competing concerns, the Board is proposing two alternative definitions of a "qualified mortgage." Alternative 1 defines a "qualified mortgage" based on the criteria listed in the Act, and the definition operates as a legal safe harbor and alternative to complying with the general ability-to-repay standard. Alternative 1 does not define a "qualified mortgage" to include a requirement to consider the consumer's debt-to-income ratio or residual income. Because of the discretion inherent in making these calculations, such a requirement would not provide certainty that the loan is a qualified mortgage.

Alternative 2 defines a "qualified mortgage" to include the requirements listed in the Act as well as the other underwriting requirements that are in the general ability-to-repay standard (*i.e.,* employment status, simultaneous loans, current debt obligations, debt-to-income ratio, and credit history). The definition provides a presumption of compliance that could be rebutted by the consumer.

Limits on points and fees. The Dodd-Frank Act defines a "qualified mortgage" as a loan for which, among other things, the total points and fees do not exceed three percent of the total loan amount. In addition, the Act requires the Board to prescribe rules adjusting this threshold for "smaller loans" and to "consider the potential impact of such rules on rural areas and other areas where home values are lower." If the threshold were not adjusted for smaller loans, then creditors might not be able to recover their fixed costs for originating the loan. This could deter some creditors from originating smaller loans, thus reducing access to credit.

The Board is proposing two alternatives for implementing the limits on points and fees for qualified mortgages. Alternative A is based on certain tiers of loan amounts (*e.g.,* a points and fees threshold of 3.5 percent of the total loan amount for a loan amount greater than or equal to $60,000 but less than $75,000). Alternative A is designed to be an easier calculation for creditors, but may result in some anomalies (*e.g.,* a points and fees threshold of $2,250 for a $75,000 loan, but a points and fees threshold of $2,450 for a $70,000 loan). Alternative B is designed to remedy these anomalies by providing a more precise sliding scale, but may be cumbersome for some creditors. The proposal solicits comment on these approaches.

Definition of "points and fees." Generally, a qualified mortgage cannot have points and fees that exceed three percent of the total loan amount. Consistent with the Act, the proposal revises Regulation Z to define "points and fees" to now include: (1) Certain mortgage insurance premiums in excess of the amount payable under Federal Housing Administration provisions; (2) all compensation paid directly or indirectly by a consumer or creditor to a loan originator; and (3) the prepayment penalty on the covered transaction, or on the existing loan if it is refinanced by the same creditor. The proposal also provides exceptions to the calculation of points and fees for: (1) Any bona fide third party charge not retained by the creditor, loan originator, or an affiliate of either, and (2) certain bona fide discount points.

Underwriting requirements. As discussed above, it is not clear whether the Act intends the definition of a "qualified mortgage" to be a somewhat narrowly-defined safe harbor or a more broadly-defined presumption of compliance. For this reason, the Board is proposing two alternative definitions with respect to the underwriting requirements. Under Alternative 1, the underwriting requirements for a qualified mortgage are limited to requiring a creditor to consider and verify the consumer's current or reasonably expected income or assets. Under Alternative 2, the definition of a qualified mortgage requires a creditor to consider and verify all of the underwriting factors required under the general ability-to-repay standard, namely: (1) The currently or reasonably expected income, (2) the employment status, (3) the monthly payment on any simultaneous loan, (4) the current debt obligations, (5) the monthly debt-to-income ratio or residual income, and (6) the credit history.

Payment calculations. Consistent with the Dodd-Frank Act, the proposal defines a qualified mortgage to require the creditor to calculate the mortgage payment using the periodic payment of principal and interest based on the maximum interest rate that may apply during the first five years after consummation.

Balloon-Payment Qualified Mortgages Made by Certain Creditors

The Board is exercising the authority provided under the Dodd-Frank Act to provide an exception to the definition of a "qualified mortgage" for a balloon-payment loan made by a creditor that meets the criteria set forth in the Act. Based on outreach, it appears that some community banks make short-term balloon loans as a means of hedging against interest rate risk, and that the community banks typically hold these loans in portfolio. The Board believes Congress enacted this exception to ensure access to credit in rural and underserved areas where consumers may be able to obtain credit only from such community banks offering these balloon-payment loans. This exception is similar to the exemption from the escrow requirements provided in another section of the Dodd-Frank Act.

The proposal provides an exception for a creditor that meets the following four criteria, with some alternatives:

(1) *Operates in predominantly rural or underserved areas.* The creditor, during the preceding calendar year, must have extended more than 50% of its total covered transactions that provide for balloon payments in one or more counties designated by the Board as "rural" or "underserved."

(2) *Total annual covered transactions.* Under Alternative 1, the creditor, together with all affiliates, extended covered transactions of some dollar amount or less during the preceding calendar year. Under Alternative 2, the creditor, together with all affiliates, extended some number of covered transactions or fewer during the preceding calendar year. The proposal solicits comment on an appropriate dollar amount or number of transactions.

(3) *Balloon loans in portfolio.* Under Alternative 1, the creditor must not sell any balloon-payment loans on or after the effective date of the final rule. Under Alternative 2, the creditor must not have sold any balloon-payment loans during the preceding and current calendar year.

(4) *Asset size.* The creditor must meet an asset size threshold set annually by the Board, which for calendar year 2011 would be $2 billion.

Limits on loan features. The Dodd-Frank Act generally provides that a balloon-payment qualified mortgage contains the same limits on loan features and the loan term as a qualified mortgage, except for allowing the balloon payment. In addition, the Board is using its adjustment and exception authority and discretionary regulatory authority to add a requirement that the loan term be five years or longer. The Board believes that this requirement would help ensure the consumer's ability to repay the loan by providing more time for the consumer to build equity.

Points and fees and underwriting requirements. Consistent with the Dodd-Frank Act, the proposal requires that a balloon-payment qualified mortgage provide for the same limits on points and fees and underwriting requirements as a qualified mortgage.

Payment calculations. Consistent with the Dodd-Frank Act, the proposal provides that a creditor may underwrite a balloon-payment qualified mortgage using all of the scheduled payments, except the balloon payment.

Other Protections

Limits on prepayment penalties. Consistent with the Dodd-Frank Act, the proposal provides that a covered transaction may not include a prepayment penalty unless the transaction: (1) Has an APR that cannot increase after consummation (*i.e.,* a fixed-rate or step-rate mortgage), (2) is a qualified mortgage, and (3) is not a higher-priced mortgage loan. The proposal further provides, consistent with the Act, that the prepayment penalty may not exceed three percent of the outstanding loan balance during the first year after consummation, two percent during the second year after consummation, and one percent during the third year after consummation. Prepayment penalties are not permitted after the end of the third year after consummation. Finally, pursuant to the Act, the proposal requires a creditor offering a consumer a loan with a prepayment penalty to also offer that consumer a loan without a prepayment penalty.

Expansion of record retention rules. Currently, Regulation Z requires creditors to retain evidence of compliance for two years after disclosures must be made or action must be taken. The Dodd-Frank Act extends the statute of limitations for civil liability for a violation of the prepayment penalty provisions or ability-to-repay provisions (including the qualified mortgage provisions) to three years after the date of a violation. The proposal revises Regulation Z to lengthen the record retention requirement to three years after consummation for consistency with the Dodd-Frank Act.

Prohibition on evasion through open-end credit. Currently, Regulation Z prohibits a creditor from structuring a closed-end loan as an open-end plan to evade the requirements for higher-priced mortgage loans. The Board is using its adjustment and exception authority and discretionary regulatory authority to include a similar provision in this proposal in order to prevent circumvention or evasion.

V. Section-by-Section Analysis

Section 226.25 Record Retention

25(a) General Rule

Currently, § 226.25(a) requires that creditors retain evidence of compliance with Regulation Z for two years after disclosures must be made or action must be taken. Section 226.25(a) also clarifies that administrative agencies responsible for enforcing Regulation Z may require creditors under their jurisdictions to retain records for a longer period, if necessary to carry out their enforcement responsibilities under TILA Section 108. 15 U.S.C. 1607. Under TILA Section 130(e), the statute of limitations for civil liability for a violation of TILA is one year after the date a violation occurs. 15 U.S.C. 1640.

The proposal would implement the requirement to consider a consumer's repayment ability under TILA Section 129C(a), alternative requirements for "qualified mortgages" under TILA Section 129C(b), and prepayment penalty requirements under TILA Section 129C(c) in proposed § 226.43, as discussed in detail below. Section 1416 of the Dodd-Frank Act extends the statute of limitations for civil liability for a violation of TILA Section 129C, among other provisions, to three years after the date a violation occurs. Accordingly, the Board proposes to revise § 226.25(a) to require that creditors retain records that evidence compliance with proposed § 226.43 for at least three years after consummation. Although creditors will take action required under proposed § 226.43 (underwriting covered transactions and offering consumers the option of a covered transaction without a prepayment penalty) before a transaction is consummated, the Board believes calculating the record retention period from the time of consummation would facilitate compliance by establishing a clear time period for record retention. The proposal to extend the required period for retention of evidence of compliance with § 226.43 would not affect the record retention period for other requirements under Regulation Z. Increasing the period creditors must retain records evidencing compliance with § 226.43 from two to three years would increase creditors' compliance burden. The Board believes many creditors will retain such records for at least three years, even in the absence of a change to record retention requirements, due to the extension of the statute of limitations for civil liability.

Currently, comment 25(a)–2 clarifies that in general creditors need retain only enough information to reconstruct the required disclosures or other records. The Board proposes a new comment 25(a)–6 that clarifies that if a creditor must verify and document information used in underwriting a transaction subject to proposed § 226.43, the creditor should retain evidence sufficient to demonstrate compliance with the documentation requirements of § 226.25(a). Proposed comment 25(a)–6 also clarifies that creditors need not retain actual paper copies of the documentation used to underwrite a transaction, but they should be able to reproduce those records accurately, for example, by retaining a reproduction of a consumer's Internal Revenue Service Form W–2 rather than merely the income information on the form. The Board also proposes to revise comment 25(a)–2 to remove obsolete references to particular documentation methods and to reflect that in some cases creditors must be able to reproduce (not merely reconstruct) records.

Proposed comment 25(a)–7 provides guidance regarding retention of records evidencing compliance with the requirement to offer a consumer an alternative covered transaction without a prepayment penalty, discussed below in the section-by-section analyses of proposed § 226.43(g)(3) through (5). Proposed comment 25(a)–7 clarifies that creditors must retain records that document compliance with that requirement if a transaction subject to proposed § 226.43 is consummated with a prepayment penalty, but need not retain such records if a covered transaction is consummated without a prepayment penalty or a covered transaction is not consummated. *See* proposed § 226.43(g)(6). The Board believes the requirement to offer a transaction without a prepayment penalty under TILA Section 129C(c)(4) is intended to ensure that consumers can voluntarily choose an alternative covered transaction with a prepayment penalty. The Board therefore believes it is unnecessary for creditors to document compliance with the offer requirement when a consumer does not choose a transaction with a prepayment penalty, or if the covered transaction is not consummated.

As discussed in detail below in the section-by-section analysis of proposed § 226.43(g)(4), if the creditor offers a covered transaction with a prepayment penalty through a mortgage broker, the creditor must present the mortgage broker an alternative covered transaction without a prepayment penalty. Also, the creditor must provide, by agreement, for the mortgage broker to present the consumer that transaction or an alternative covered transaction without a prepayment penalty offered by another creditor that has a lower interest rate or a lower total dollar amount of origination points or fees and discount points. Proposed comment 25(a)–7 clarifies that, to evidence compliance with proposed § 226.43(g)(4), the creditor should retain a record of (1) the alternative covered transaction without a prepayment penalty presented to the mortgage broker pursuant to proposed § 226.43(g)(4)(i), such as a rate sheet, and (2) the agreement with the mortgage broker required by proposed § 226.34(g)(4)(ii).

Section 226.32 Requirements for Certain Closed-End Home Mortgages

Introduction

The Board proposes to revise the definition of "points and fees" in § 226.32(b)(1) to incorporate amendments to this definition under the Dodd-Frank Act.[6] Formerly, the definition of "points and fees" in both TILA and Regulation Z applied only for determining whether a home mortgage is a "high-cost mortgage" under TILA. *See* TILA Section 103(aa)(4), 15 U.S.C. 1602(aa)(4); § 226.32. As discussed earlier, however, the Dodd-Frank Act amended TILA to create a new type of mortgage—a "qualified mortgage"—to which certain limits on the points and fees that may be charged apply.[7] Under the new TILA amendments, the term "points and fees" for qualified mortgages has the same meaning as "points and fees" for high-cost mortgages.

The Board proposes amendments to the definition of "points and fees" to implement the limitation on points and fees for qualified mortgages. The Board is not currently proposing regulations to implement the Dodd-Frank Act's amendments to TILA's high-cost mortgage rules generally.[8] For example, the Board is not proposing at this time to implement revisions to the points and fees thresholds for high-cost mortgages that exclude from the threshold

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[6] Public Law 111–203, 124 Stat. 1376, Title XIV, § 1431.

[7] *Id.* § 1412; TILA Section 129C(b)(2)(A)(vii), (b)(2)(C)(i); 15 U.S.C. 1639c(b)(2)(A)(vii), (b)(2)(C)(i).

[8] *Id.* § 1431–1433. The Dodd-Frank Act defines a high-cost mortgage to include a mortgage for which "the total points and fees payable in connection with the transaction, other than bona fide third party charges not retained by the mortgage originator, creditor, or an affiliate of the creditor or mortgage originator, exceed—(I) in the case of a transaction for $20,000 or more, 5 percent of the total transaction amount; or (II) in the case of a transaction for less than $20,000, the lesser of 8 percent of the total transaction amount or $1,000 (or such other dollar amount as the Board shall prescribe by regulation." *Id.* § 1431(a); TILA Section 103(aa)(1)(A)(ii); 15 U.S.C. 1602(aa)(1)(A)(ii).

calculation "bona fide third party charges not retained by the mortgage originator, creditor, or an affiliate of the creditor or mortgage originator" and that permit creditors to exclude certain "bona fide discount points." [9] By contrast, identical provisions in the Dodd-Frank Act defining the points and fees threshold for qualified mortgages are proposed to be implemented in new § 226.43(e)(3), discussed below.[10]

32(a) Coverage

32(a)(1) Calculation of the "Total Loan Amount"

TILA Section 129C(b)(2)(A)(vii) defines a "qualified mortgage" as a mortgage for which, among other things, "the total points and fees [] payable in connection with the loan do not exceed 3 percent of the *total loan amount*" (emphasis added).[11] Therefore, for purposes of implementing the qualified mortgage provisions, the Board proposes to retain existing comment 32(a)(1)(ii)–1 explaining the meaning of the term "total loan amount," with the minor revisions discussed below.

First, the proposal revises the "total loan amount" calculation under current comment 32(a)(1)(ii)–1 to account for charges added to TILA's definition of points and fees by the Dodd-Frank Act (proposed to be implemented under revisions to § 226.32(b)(1), discussed below). Under Regulation Z, the "total loan amount" is calculated to ensure that the allowable points and fees is a percentage of the amount of credit extended to the consumer, without taking into account the financed points and fees themselves. Specifically, under current comment 32(a)(1)(ii)–1, the "total loan amount" is calculated by "taking the amount financed, as determined according to § 226.18(b), and deducting any cost listed in § 226.32(b)(1)(iii) and § 226.32(b)(1)(iv) that is both included as points and fees under § 226.32(b)(1) and financed by the creditor." Section 226.32(b)(1)(iii) and (b)(1)(iv) pertain to "real estate-related fees" listed in § 226.4(c)(7) and premiums or other charges for credit insurance or debt cancellation coverage, respectively.

The Board proposes to revise this comment to cross-reference additional financed points and fees described in proposed § 226.32(b)(1)(vi) as well. This addition would require a creditor also to deduct from the amount financed any prepayment penalties that are "incurred by the consumer if the mortgage loan refinances a previous loan made or currently held by the creditor refinancing the loan or an affiliate of the creditor"—to the extent that the prepayment penalties are financed by the creditor into the new loan. *See* proposed § 226.32(b)(1)(vi), implementing TILA Section 103(aa)(4)(F). In this way, the three percent limit on points and fees for qualified mortgages will be based on the amount of credit extended to the borrower without taking into account the financed points and fees themselves.

The proposal also revises one of the commentary's examples of the "total loan amount" calculation. Specifically, the Board proposes to revise the example of a $500 single premium for optional "credit life insurance" used in comment 32(b)(1)(i)–1.iv to be a $500 single premium for optional "credit unemployment insurance." This change is proposed because, under the Dodd-Frank Act, single-premium credit insurance—including credit life insurance—is prohibited in covered transactions except for certain limited types of credit unemployment insurance.[12] *See* TILA Section 129C(d); 15 U.S.C. 1639c(d).

Alternative calculation of "total loan amount" based on the "principal loan amount." As noted, currently the "total loan amount" is calculated by taking the "amount financed" (as determined under § 226.18(b)) and deducting any cost listed in § 226.32(b)(1)(iii) and § 226.32(b)(1)(iv) that is both included as points and fees under § 226.32(b)(1) and financed by the creditor. The Board requests comment on whether to streamline the calculation to better ensure that the "total loan amount" includes all credit extended other than financed points and fees.

Specifically, the Board solicits comment on whether to revise the calculation of "total loan amount" to be the following: "principal loan amount" (as defined in § 226.18(b) and accompanying commentary), minus charges that are points and fees under § 226.32(b)(1) and are financed by the creditor. The purpose of using the "principal loan amount" instead of the "amount financed" would be to streamline the calculation to facilitate compliance and to ensure that no charges other than financed points and fees are excluded from the "total loan amount." In general, the revised calculation would yield a larger "total loan amount" to which the percentage points and fees thresholds would have to be applied than would the proposed (and existing) "total loan amount" calculation, because only financed points and fees and no other financed amounts would be excluded. Thus, creditors in some cases would be able to charge more points and fees on the same loan than under the proposed (and existing) rule.

To illustrate, under the proposed (and current) rule, the "total loan amount" for a loan with a "principal loan amount" of $100,000 and a $3,000 upfront mortgage insurance premium is $97,000. This is because the "amount financed," from which the "total loan amount" is derived, excludes prepaid finance charges. The $3,000 upfront mortgage origination charge meets the definition of a prepaid finance charge (*see* § 226.2(a)(23)) and thus would be excluded from the "principal loan amount" to derive the "amount financed." The "total loan amount" is the "amount financed" ($97,000) minus any points and fees listed in § 226.32(b)(1)(iii) or (b)(1)(iv) that are financed. In this example, there are no charges under § 226.32(b)(1)(iii) or (b)(1)(iv), so the "total loan amount" is $97,000. The allowable points and fees under the qualified mortgage test in this example is three percent of $97,000 or $2,910.

If the "total loan amount" is derived simply by subtracting from the "principal loan amount" all points and fees that are financed, however, a different result occurs. In the example above, assume that the allowable upfront mortgage insurance premium

[9] Public Law 111–203, 124 Stat. 1376, Title XIV, § 1431(a) and (d); TILA Section 103(aa)(1) and (dd); 15 U.S.C. 1602(aa)(1) and (dd).

[10] Public Law 111–203, 124 Stat. 1376, Title XIV, § 1412; TILA Section 129C(b)(2)(C); 15 U.S.C. 1639c(b)(2)(C). Thus, if the rule on qualified mortgages is finalized prior to the rule on high-cost mortgages, the calculation of the points and fees threshold for each type of mortgage would be different, but the baseline definition of "points and fees" would be the same.

[11] Similarly, prior to being revised by the Dodd-Frank Act, TILA Section 103(aa)(1)(B) defined a high-cost mortgage to include a mortgage for which "the total points and fees payable by the consumer at or before closing will exceed the greater of (i) eight percent of the *total loan amount;* or (ii) $400" (emphasis added). Regulation Z currently defines a high-cost mortgage to include a loan for which the total points and fees payable by the consumer at or before closing exceed a certain percentage of the "total loan amount" or a dollar amount adjusted annually for inflation. *See* § 226.32(a)(1)(ii). Commentary to § 226.32(a)(1)(ii) explains the term "total loan amount." *See* comment 32(a)(1)(ii)–1. Section 1431 of the Dodd-Frank Act now defines a high-cost mortgage to include a mortgage for which the points and fees do not exceed a certain percentage of the "total transaction amount," rather than using the term "total loan amount." TILA Section 103(aa)(1)(A)(ii). The Dodd-Frank Act does not define the term "total transaction amount." However, as discussed above, the Board is not at this time proposing to revise the definition of high-cost mortgage in § 226.32 to implement Dodd-Frank Act amendments to TILA's high-cost mortgage provisions.

[12] Public Law 111–203, 124 Stat. 1376, Title XIV, § 1414. The Board is not at this time proposing to implement the restrictions on single-premium credit insurance under the Dodd-Frank Act.

for FHA loans is $2,000. Under proposed § 226.32(b)(1)(i)(B) (discussed in detail below), only the $1,000 difference between the $3,000 upfront private mortgage insurance premium and the $2,000 amount that would be allowable for an FHA loan must be counted as points and fees. To determine the "total loan amount," the creditor would subtract $1,000 from the "principal loan amount" ($100,000), resulting in $99,000. The allowable points and fees under the qualified mortgage test in this example is three percent of $99,000 or $2,970.

The Board requests comment on the proposed revisions to the comment explaining how to calculate the "total loan amount," including whether additional guidance is needed.

32(b) Definitions

32(b)(1)

The proposed rule would revise existing elements of Regulation Z's definition of "points and fees" (see proposed § 226.32(b)(1)(i)–(iv)) and add certain items not previously included in "points and fees" but now mandated by statute to be included (see proposed § 226.32(b)(1)(v) and (vi)). These changes are discussed in turn below.

32(b)(1)(i) Finance Charge

Current § 226.32(b)(1)(i) requires that "points and fees" include "all items required to be disclosed under § 226.4(a) and 226.4(b)"—the provisions that define the term "finance charge" —"except interest or the time-price differential." Proposed § 226.32(b)(1)(i) would revise the current provision to include in points and fees "all items considered to be a finance charge under § 226.4(a) and 226.4(b), *except*—

- Interest or the time-price differential; and
- Any premium or charge for any guarantee or insurance protecting the creditor against the consumer's default or other credit loss to the extent that the premium or charge is assessed—
  - in connection with any Federal or state agency program;
  - not in excess of the amount payable under policies in effect at the time of origination under Section 203(c)(2)(A) of the National Housing Act (12 U.S.C. 1709(c)(2)(A)) (*i.e.,* for Federal Housing Administration (FHA) loans), provided that the premium or charge is required to be refundable on a pro-rated basis and the refund is automatically issued upon notification of the satisfaction of the underlying mortgage loan; or
  - payable after the loan closing.

See proposed § 226.32(b)(1)(i)(A)-(C).

The Board proposes to revise the existing phrase, "all items *required to be disclosed* under § 226.4(a) and 226.4(b)" to read, "all items *considered to be a finance charge* under § 226.4(a) and 226.4(b)" in part because § 226.4 itself does not require disclosure of the finance charge (see instead, for example, § 226.18(d)).

The Board also proposes to revise comment 32(b)(1)(i)–1. Existing comment 32(b)(1)(i)–1 states that § 226.32(b)(1)(i) includes in the total "points and fees" items defined as finance charges under § 226.4(a) and 226.4(b). The comment explains that items excluded from the finance charge under other provisions of § 226.4 are not included in the total "points and fees" under § 226.32(b)(1)(i), but may be included in "points and fees" under § 226.32(b)(1)(ii) and 226.32(b)(1)(iii). The Board proposes to revise this comment to state that items excluded from the finance charge under other provision of § 226.4 may be included in "points and fee" under § 226.32(b)(1)(ii) through 226.32(b)(1)(vi). This change is proposed to reflect the additional items added to the definition of "points and fees" by the Dodd-Frank Act and to correct the previous omission of § 226.32(b)(1)(iv).

In addition, the Board proposes to incorporate into this comment an example of how this rule operates. Thus, the proposed comment notes that a fee imposed by the creditor for an appraisal performed by an employee of the creditor meets the definition of "finance charge" under § 226.4(a) as "any charge payable directly or indirectly by the consumer and imposed directly or indirectly by the creditor as an incident to or a condition of the extension of credit." However, § 226.4(c)(7) expressly provides that appraisal fees are not finance charges. Therefore, under the general rule regarding the finance charges that must be counted as points and fees, a fee imposed by the creditor for an appraisal performed by an employee of the creditor would not be counted in points and fees. Section 226.32(b)(1)(iii), however, expressly includes in points and fees items listed in § 226.4(c)(7) (including appraisal fees) if the creditor receives compensation in connection with the charge. A creditor would receive compensation for an appraisal performed by its own employee. Thus, the appraisal fee in this example must be included in the calculation of points and fees. Comment 32(b)(1)(i)–1 is also proposed to be updated to include cross-references that correspond to provisions added to the definition of "points and fees" by the Dodd-Frank Act (*see* proposed § 226.32(b)(1)(v) and (b)(1)(vi)).

32(b)(1)(i)(B) Mortgage Insurance

Proposed § 226.32(b)(1)(i)(B) adds a new provision to the current definition of "points and fees" regarding charges for mortgage insurance and similar products. As stated above, under this provision, points and fees would include all items considered to be a finance charge under § 226.4(a) and 226.4(b) except mortgage insurance premiums or mortgage guarantee charges or fees to the extent that the premium or charge is—

- assessed in connection with any Federal or state agency program;
- not in excess of the amount payable under FHA mortgage insurance policies (provided that the premium or charge is required to be refundable on a pro-rated basis and the refund is automatically issued upon notification of the satisfaction of the underlying mortgage loan); or
- payable after the loan closing.

This provision implements TILA Section 103(aa)(1)(C), which specifies how "mortgage insurance" should be treated in the statutory definition of points and fees under TILA Section 103(aa)(4).

Exclusion of government insurance premiums and guaranty fees. The Board proposes to incorporate the new statutory exclusion from points and fees of "any premium provided by an agency of the Federal Government or an agency of a State," with revisions. TILA Section 103(aa)(1)(C)(i). Specifically, the proposal excludes "any premium or charge for any guaranty or insurance" under a Federal or state government program. *See* proposed § 226.32(b)(1)(i)(B)(*1*). Proposed comment 32(b)(1)(i)–2 explains that, under § 226.32(b)(1)(i)(B)(*1*) and (*3*), upfront mortgage insurance premiums or guaranty fees in connection with a Federal or state agency program are not "points and fees," even though they are finance charges under § 226.4(a) and (b). The comment provides the following example: If a consumer is required to pay a $2,000 mortgage insurance premium before or at closing for a loan insured by the U.S. Federal Housing Administration, the $2,000 must be treated as a finance charge but need not be counted in "points and fees."

The Board interprets the statute to exclude from points and fees not only upfront mortgage insurance premiums under government programs but also charges for mortgage guaranties under government programs, which typically are assessed upfront as well. The proposed exclusion from points and fees of both mortgage insurance premiums and guaranty fees under government programs is also supported by the Board's authority under TILA Section 105(a) to make adjustments to facilitate compliance with TILA and to effectuate the purposes of TILA. 15 U.S.C. 1604(a). The exclusion is further supported by the Board's authority under TILA Section 129B(e) to condition terms, acts or practices relating to residential mortgage loans that the Board finds necessary or proper to effectuate the purposes of TILA. 15 U.S.C. 1639b(e). The purposes of TILA include "assur[ing] that consumers are offered and receive residential mortgage loan on terms that reasonably reflect their ability to repay the loans." TILA Section 129B(a)(2); 15 U.S.C. 1629b(a)(2).

Representatives of both the U.S. Department of Veterans Affairs (VA) and the U.S. Department of Agriculture (USDA) expressed concerns to Board staff that the statute, which excludes only "premiums" under government programs, could be read to mean that upfront charges for guaranties offered under loan programs of these agencies and any state agencies must be counted in "points and fees." The Board understands that this interpretation of the statute could disrupt these loan guaranty programs, jeopardizing an important home mortgage credit resource for many consumers. According to VA representatives, for example, if VA "funding fees" for the VA mortgage loan guaranty are included in points and fees, for example, VA loans might exceed high-cost mortgage thresholds and likely would exceed the points and fees cap for a qualified mortgage.[13] In sum, the Board believes that the proposal is necessary to ensure consumer's access to credit through state and Federal government programs.

The Board requests comment on the proposal to exclude from "points and fees" upfront premiums as well as charges for any insurance or guaranty under a Federal or state government program.

Inclusion of upfront private mortgage insurance. Proposed § 226.32(b)(1)(i)(B)(*2*) excludes from points and fees any premium or charge for any guaranty or insurance protecting the creditor against the consumer's default or other credit loss to the extent the premium or charge does not exceed the amount payable under policies in effect at the time of origination under Section 203(c)(2)(A) of the National Housing Act (12 U.S.C. 1709(c)(2)(A)) (*i.e.,* for Federal Housing Administration (FHA) loans). Upfront private mortgage insurance charges may only be excluded from points and fees, however, if the premium or charge is required to be refundable on a pro-rated basis and the refund is automatically issued upon notification of the satisfaction of the underlying mortgage loan. Proposed § 226.32(b)(1)(i)(B)(*3*) excludes from points and fees any premium or charge for any guarantee or insurance protecting the creditor against the consumer's default or other credit loss to the extent that the premium or charge is payable after the loan closing.

Comment 32(b)(1)(i)–3 explains that, under proposed § 226.32(b)(1)(i)(B)(*2*) and (*3*), upfront private mortgage insurance premiums are not "points and fees," even though they are finance charges under § 226.4(a) and (b)—but only to the extent that the premium amount does not exceed the amount payable under policies in effect at the time of origination under Section 203(c)(2)(A) of the National Housing Act (12 U.S.C. 1709(c)(2)(A)). In addition, upfront private mortgage insurance premiums are excluded from "points and fees" only if they are required to be refunded on a pro rata basis and the refund is automatically issued upon notification of the satisfaction of the underlying mortgage loan. This comment provides the following example: Assume that a $3,000 upfront private mortgage insurance premium charged on a covered transaction is required to be refunded on a pro rata basis and automatically issued upon notification of the satisfaction of the underlying mortgage loan. Assume also that the maximum upfront premium allowable under the National Housing Act is $2,000. In this case, the creditor could exclude $2,000 from "points and fees" but would have to include in points and fees the remaining $1,000, because this is the amount that exceeds the allowable premium under the National Housing Act. However, if the $3,000 upfront private mortgage insurance premium were not required to be refunded on a pro rata basis and automatically issued upon notification of the satisfaction of the underlying mortgage loan, the entire $3,000 premium must be included in "points and fees."

Proposed comment 32(b)(1)(i)–4 explains that upfront private mortgage insurance premiums that do not qualify for an exclusion from "points and fees" under § 226.32(b)(1)(i)(B)(*2*) must be included in "points and fees" whether paid before or at closing, in cash or financed, and whether the insurance is optional or required. This comment further explains that these charges are also included whether the amount represents the entire premium or an initial payment. This proposed comment is consistent with existing comment 32(b)(1)(iv)–1 regarding the treatment of credit insurance premiums.

TILA's new mortgage insurance provision could plausibly be interpreted to apply to the definition of points and fees solely for purposes of high-cost mortgages and not for qualified mortgages. In this regard, the Board notes that the statutory provision mandating a three percent cap on points and fees for qualified mortgages specifically cross-references TILA Section 103(aa)(4) for the definition of "points and fees" applicable to qualified mortgages. The provision on mortgage insurance, however, does not appear in TILA Section 103(aa)(4), but appears rather as part of the general definition of a high-cost mortgage. *See* TILA Section 103(aa)(1). The Board also notes that certain provisions in the Dodd-Frank Act's high-cost mortgage section regarding points and fees are repeated in the qualified mortgage section on points and fees. For example, both the high-cost mortgage provisions and the qualified mortgage provisions expressly exclude from points and fees "bona fide third party charges not retained by the mortgage originator, creditor, or an affiliate of the creditor or mortgage originator." TILA Sections 103(aa)(1)(A)(ii) (for high-cost mortgages), 129C(b)(2)(C)(i) (for qualified mortgages). The mortgage insurance provision, however, does not separately appear in the qualified mortgage section.

Nonetheless, the Board believes that the better interpretation of the statute is that the mortgage insurance provision in TILA Section 103(aa)(1)(C) applies to the meaning of points and fees for both high-cost mortgages and qualified mortgages. The statute's structure reasonably supports this view: By its plain language, the mortgage insurance provision prescribes how points and fees should be computed "for purposes of paragraph (4)"—namely, for purposes of TILA Section 103(aa)(4). The mortgage insurance provision contains no caveat limiting its application solely to the points and fees calculation for high-cost mortgages. The cross-reference in the qualified mortgage provisions to TILA Section 103(aa)(4) appropriately can be read to include provisions that expressly prescribe how points and fees should be calculated under TILA Section 103(aa)(4), wherever located.

[13] The statute authorizes certain agencies, including the VA and USDA, to prescribe rules defining the loans under their programs that are qualified mortgages; until those rules take effect, however, it appears that even loans under government programs will be subject to the general ability-to-repay requirements and the criteria for qualified mortgages. *See* TILA Section 129C(b)(3)(ii).

Applying the mortgage insurance provision to the meaning of points and fees for both high-cost mortgages and qualified mortgages is also supported by the Board's authority under TILA Section 105(a) to make adjustments to facilitate compliance with TILA 15 U.S.C. 1604(a). The exclusion is further supported by the Board's authority under TILA Section 129B(e) to condition terms, acts or practices relating to residential mortgage loans that the Board finds necessary or proper to effectuate the purposes of TILA. 15 U.S.C. 1639b(e). The purposes of TILA include "assur[ing] that consumers are offered and receive residential mortgage loan on terms that reasonably reflect their ability to repay the loans." TILA Section 129B(a)(2); 15 U.S.C. 1629b(a)(2).

From a practical standpoint, the Board is concerned about the increased risk of confusion and compliance error if points and fees has two separate meanings in TILA—one for determining whether a loan is a high-cost mortgage and another for determining whether a loan is a qualified mortgage. The proposal is intended to facilitate compliance by applying the mortgage insurance provision to the meaning of points and fees for both high-cost mortgages and qualified mortgages.

In addition, the Board is concerned that market distortions could result due to different treatment of mortgage insurance in calculating points and fees for high-cost mortgages and qualified mortgages. As noted, "points and fees" for both high-cost mortgages and qualified mortgages generally excludes "bona fide third party charges not retained by the mortgage originator, creditor, or an affiliate of the creditor or mortgage originator." TILA Sections 103(aa)(1)(A)(ii), 129C(b)(2)(C)(i). Under this general provision standing alone, premiums for upfront private mortgage insurance would be excluded from points and fees. However, as noted, the statute's specific provision on mortgage insurance (TILA Section 103(aa)(1)(C)) requires that any portion of upfront premiums for private mortgage insurance that exceeds amounts allowable for upfront insurance premiums in FHA mortgage loan transactions be counted in points and fees. It further provides that upfront private mortgage insurance premiums must be included in points and fees if they are not required to be refunded on a pro rata basis and the refund is not automatically issued upon notification of the satisfaction of the underlying mortgage loan.

Narrowly applying the mortgage insurance provision to the definition of points and fees only for high-cost mortgages would mean that any premium amount for upfront private mortgage insurance could be charged on qualified mortgages; in most cases, none of that amount would be subject to the cap on points and fees for qualified mortgages because it would be excluded as a "bona fide third party fee" that is not retained by the creditor, loan originator, or an affiliate of either. As a result, consumers of qualified mortgages could be vulnerable to paying excessive upfront private mortgage insurance costs. In the Board's view, this outcome would undercut Congress's clear intent to ensure that qualified mortgages are products with limited fees and more safe features.

32(b)(1)(ii) Loan Originator Compensation

The Board proposes revisions to § 226.32(b)(ii) to reflect statutory amendments under the Dodd-Frank Act. Current § 226.32(b)(ii) requires inclusion in points and fees of "all compensation paid to a mortgage broker." Proposed § 226.32(b)(ii) would implement a new statutory provision that requires inclusion in points and fees of "all compensation paid directly or indirectly by a consumer or creditor to a mortgage originator from any source, including a mortgage originator that is also the creditor in a table-funded transaction." *See* TILA Section 103(aa)(4)(B), 15 U.S.C. 1602(aa)(4)(B). Consistent with the statute, the Board also proposes to exclude from points and fees compensation paid to certain persons. *See* proposed § 226.32(b)(2), discussed below.

Proposed § 226.32(b)(1)(ii) mirrors the statutory language, with two exceptions. First, the statute requires inclusion of "compensation paid directly or indirectly by a consumer or creditor to a mortgage originator *from any source.* * * *" The proposed rule does not include the phrase "from any source" because the provision expressly covers compensation paid "directly or indirectly" to the loan originator, which would have the same effect. The Board requests comment on whether any reason exists to include the phrase "from any source" to describe loan originator compensation for purposes of implementing TILA Section 103(aa)(4)(B).

Second, the proposal uses the term "loan originator" as defined in § 226.36(a)(1),[14] not the term "mortgage originator" under Section 1401 of the Dodd-Frank Act.[15] *See* TILA Section 103(cc)(2); 15 U.S.C. 1602(cc)(2). The term "loan originator" is used for consistency with existing Regulation Z provisions under § 226.36. The Board believes that the term "loan originator," as defined in § 226.36(a)(1), is appropriately used in proposed § 226.32(b)(1)(ii) because the meaning of "loan originator" under § 226.36(a)(1) and the statutory definition of "mortgage originator" are consistent in several key respects, discussed below.

In addition, new § 226.32(b)(2) would account for the distinctions between the Dodd-Frank Act's definition of "mortgage originator" and the definition of "loan originator" under § 226.36(a)(1). Proposed § 226.32(b)(2) exempts from points and fees compensation paid to certain persons expressly excluded from the statutory definition of "mortgage originator." *See* section-by-section analysis of § 226.32(b)(2), below. Use of the term "loan originator" in proposed § 226.32(b)(1)(ii).

Loan originator functions. The Dodd-Frank Act defines the term "mortgage originator" to mean "any person who, for direct or indirect compensation or gain, or in the expectation of direct or indirect compensation or gain—(i) takes a residential mortgage loan application; (ii) assists a consumer in obtaining or applying to obtain a residential mortgage loan; or (iii) offers or negotiates terms of a residential mortgage loan . * * *" TILA Section 103(cc)(2)(A). The statute further defines "assists a consumer in obtaining or applying to obtain a residential mortgage loan" to mean, "among other things, advising on residential mortgage loan terms (including rates, fees, and other costs), preparing residential mortgage loan packages, or collecting information on behalf of the consumer with regard to a residential mortgage loan."

The definition of "loan originator" in § 226.36 includes all of the activities listed in the statute as part of the definition of "mortgage originator," with one exception. Unlike the statutory definition of "mortgage originator," however, Regulation Z's definition of "loan originator" does not include "any

[14] Section 226.36(a)(1) defines the term "loan originator" to mean, "with respect to a particular transaction, a 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 credit for another person. The term 'loan originator' includes an employee of the creditor if the employee meets this definition. The term 'loan originator' includes the creditor only if the creditor does not provide the funds for the transaction at consummation out of the creditor's own resources, including drawing on a *bona fide* warehouse line of credit, or out of deposits held by the creditor." Section 226.36(a)(1).

[15] Public Law 111–203, 124 Stat. 1376, Title XIV, § 1401.

person who represents to the public, through advertising or other means of communicating or providing information (including the use of business cards, stationery, brochures, signs, rate lists, or other promotional items), that such person can or will provide any of the activities" described above. TILA Section 103(cc)(2)(B); 15 U.S.C. 1602(cc)(2)(B). The Board does not believe that adding this element of the definition of "mortgage originator" to Regulation Z's definition of "loan originator" is necessary at this time because § 226.36 and the proposed definition of "points and fees" are concerned solely with loan originators that receive compensation for performing defined origination functions. A person who solely represents to the public that he is able to offer or negotiate mortgage terms for a consumer has not yet received compensation for that function; thus, there is no compensation to account for in calculating "points and fees" for a particular transaction.

The Board solicits comment on the proposal not to include in the definition of "loan originator" a "person who represents to the public, through advertising or other means of communicating or providing information (including the use of business cards, stationery, brochures, signs, rate lists, or other promotional items), that such person can or will provide" the services of a loan originator.

Administrative tasks. The Board also believes that the definition of "loan originator" in § 226.32(a)(1) is consistent with the Dodd-Frank Act's definition of "mortgage originator" in that both exclude persons that perform solely administrative or clerical tasks. Specifically, the statute excludes any person who does not perform the tasks in the paragraph above and "who performs purely administrative or clerical tasks on behalf of a person who [performs those tasks]." TILA Section 103(cc)(2)(B); 15 U.S.C. 1602(cc)(2)(B). Similarly, Regulation Z's current definition of "loan originator" excludes "managers, administrative staff, and similar individuals who are employed by a creditor or loan originator but do not arrange, negotiate, or otherwise obtain an extension of credit for a consumer, and whose compensation is not based on whether any particular loan is originated." Comment 36(a)(1)–4.

Seller financing. In addition, the existing definition of "loan originator" in § 226.36(a)(1) is consistent with the statutory definition of "mortgage originator" in that both exclude persons and entities that provide seller financing for properties that they own. *See* TILA Section 103(cc)(2)(E); 15 U.S.C. 1602(cc)(2)(E). Under the definition of "loan originator" in § 226.36(a)(1), these persons would be "creditors"—but they are not "creditors" that use table funding. As noted below, creditors that use table funding are "loan originators" under § 226.36. However, all other "creditors" are not "loan originators." *See* 75 FR 58509, 58510 (Sept. 24, 2010).

Creditors in table-funded transactions. Both the existing definition of "loan originator" in § 226.36(a)(1) and the statutory definition of "mortgage originator" exclude the creditor, except for the creditor in a table-funded transaction. *See* TILA Section 103(cc)(2)(F); 15 U.S.C. 1602(cc)(2)(F); *see also* comment 36(a)–1.i. Both also include employees of a creditor, individual brokers and mortgage brokerage firms, including entities that close loans in their own names that are table funded by a third party.

Secondary market transactions. Finally, neither the definition of "loan originator" in § 226.36(a)(1) nor the statutory definition of "mortgage originator" includes entities that earn compensation on the sale of loans by creditors to secondary market purchasers—transactions to which consumers are not a direct party. *See generally* TILA Section 103(cc)(2); 15 U.S.C. 1602(cc)(2).

Comments 32(b)(1)(ii)–1, –2, and –3. Proposed comments 32(b)(1)(ii)–1, –2, and –3 provide guidance on the types of loan originator compensation [16] included in "points and fees." Existing comment 32(b)(1)(ii)–1 would be revised to clarify that compensation paid by either a consumer or a creditor to a loan originator, as defined in § 226.32(a)(1), is included in "points and fees." No other substantive changes are intended.

New comment 32(b)(1)(ii)–2.i would clarify that, in determining "points and fees," loan originator compensation includes the dollar value of compensation paid to a loan originator for a covered transaction, such as a bonus, commission, yield spread premium, award of merchandise, services, trips, or similar prizes, or hourly pay for the actual number of hours worked on a particular transaction. The proposed comment would further clarify that compensation paid to a loan originator for a covered transaction must be included in the "points and fees" calculation for that transaction whenever paid, whether at or before closing or anytime after closing, as long as that compensation amount can be determined at the time of closing. Thus, loan originator compensation for a covered transaction includes compensation that will be paid as part of a periodic bonus, commission, or gift if a portion of the dollar value of the bonus, commission, or gift can be attributed to that transaction.

Proposed comment 32(b)(1)(ii)–2.i then provides three examples of compensation paid to a loan originator that must be included in the points and fees calculation. The first example assumes that, according to a creditor's compensation policies, the creditor awards its loan officers a bonus every year based on the number of loan applications taken by the loan officer that result in consummated transactions during that year, and that each consummated transaction increases the bonus by $100. In this case, the $100 bonus must be counted in the amount of loan originator compensation that the creditor includes in "points and fees."

The second example assumes that, according to a creditor's compensation policies, the creditor awards its loan officers a bonus every year based on the dollar value of consummated transactions originated by the loan officer during that year. Also assumed is that, for each transaction of up to $100,000, the creditor awards its loan officers a bonus of $100; for each transaction of more than $100,000 up to $250,000, the creditor awards its loan officers $200; and for each transaction of more than $250,000, the creditor awards its loan officers $300. In this case, for a mortgage transaction of $300,000, the $300 bonus is loan originator compensation that must be included in "points and fees."

The third example assumes that, according to a creditor's compensation policies, the creditor awards its loan officers a bonus every year based on the number of consummated transactions originated by the loan officer during that year. Also assumed is that for the first 10 transactions originated by the loan officer in a given year, no bonus is awarded; for the next 10 transactions originated by the loan officer up to 20, a bonus of $100 per transaction is awarded; and for each transaction originated after the first 20, a bonus of $200 per transaction is awarded. In this case, for the first 10 transactions originated by a loan officer during a given year, no amount of loan originator compensation need be included in "points and fees." For any mortgage transaction made after the first 10, up to

[16] Loan originator compensation would, of course, need to be consistent with the Interagency Guidance on Sound Incentive Compensation Policies. 75 FR 36395, June 25, 2010.

the 20th transaction, $100 must be included in "points and fees." For any mortgage transaction made after the first 20, $200 must be included in "points and fees."

Proposed comment 32(b)(1)(ii)–2.ii clarifies that, in determining "points and fees," loan originator compensation excludes compensation that cannot be attributed to a transaction at the time of origination, including, for example:

- Compensation based on the performance of the loan originator's loans.
- Compensation based on the overall quality of a loan originator's loan files.
- The base salary of a loan originator who is also the employee of the creditor, not accounting for any bonuses, commissions, pay raises, or other financial awards based solely on a particular transaction or the number or amount of covered transactions originated by the loan originator.

Proposed comment 32(b)(1)(ii)–3 explains that loan originator compensation includes amounts the loan originator retains and is not dependent on the label or name of any fee imposed in connection with the transaction. For example, if a loan originator imposes a "processing fee" and retains the fee, the fee is loan originator compensation under paragraph 32(b)(1)(ii) whether the originator expends the fee to process the consumer's application or uses it for other expenses, such as overhead. The proposed comment is consistent with comment 36(d)(1)–1.ii for loan originator compensation.

The Board requests comment on the proposal regarding the types of loan originator compensation that must be included in points and fees, including the appropriateness of specific examples given in the commentary.

32(b)(1)(iii) Real Estate-Related Fees

Consistent with the statute, the Board proposes no changes to existing § 226.32(b)(1)(iii), which includes in points and fees "all items listed in § 226.4(c)(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." During outreach, creditor representatives raised concerns about the inclusion in points and fees of real estate-related fees paid to an affiliate of the creditor, such as an affiliated title company. These fees have historically been included in points and fees for high-cost mortgages under both TILA and Regulation Z, but the points and fees threshold for qualified mortgages is much lower than for the high-cost mortgage threshold. Thus, creditors that use affiliated settlement service providers such as title companies are concerned that they will have difficulty making loans that meet the qualified mortgage points and fees threshold.

The Board is not proposing an exemption for fees paid to creditor-affiliated settlement services providers. The Board notes that Congress appears to have rejected excluding from points and fees real estate-related fees where a creditor would receive indirect compensation as a result of obtaining distributions of profits from an affiliated entity based on the creditor's ownership interest in compliance with RESPA.[17] The Board requests comment on the proposal *not* to exclude from the points and fees calculation for qualified mortgages fees paid to creditor-affiliated settlement services providers. The Board invites commenters favoring this exclusion to explain why excluding these fees from the points and fees calculation would be consistent with the purposes of the statute.

Payable at or before closing. The Dodd-Frank Act removed the phrase "payable at or before closing" from the high-cost mortgage points and fees test in TILA Section 103(aa)(1)(B). *See* TILA Section 103(aa)(1)(A)(ii). The phrase "payable at or before closing" is also not in TILA's provisions on the points and fees cap for qualified mortgages. *See* TILA Section 129C(b)(2)(A)(vii), (b)(2)(C). Thus, with a few exceptions, any item listed in the "points and fees" definition under § 226.32(b)(1) must be counted toward the limits on points and fees for both high-cost mortgages and qualified mortgages, even if it is payable after loan closing. The exceptions are mortgage insurance premiums and charges for credit insurance and debt cancellation and suspension coverage. The statute expressly states that these premiums and charges are included in points and fees only if payable at or before closing. *See* TILA Section 103(aa)(1)(C) (for mortgage insurance) and TILA Section 103(aa)(4)(D) (for credit insurance and debt cancellation and suspension coverage). The statute does not so limit § 226.4(c)(7) charges, possibly because these charges could reasonably be viewed as charges that by definition are only payable at or before closing.[18]

Nonetheless, regarding the mortgage loan transaction costs that are deemed points and fees, the Board requests comment on whether any other types of fees should be included in points and fees only if they are "payable at or before closing." The Board is concerned that some fees that occur after closing, such as fees to modify a loan, might be deemed to be points and fees. If so, calculating the points and fees to determine whether a transaction is a qualified mortgage may be difficult because the amount of future fees (*e.g.,* loan modification fees) cannot be known prior to closing. Creditors might be exposed to excessive litigation risk if consumers were able at any point during the life of a mortgage to argue that the points and fees for the loan exceed the qualified mortgage limits due to fees imposed after loan closing. Creditors therefore might be discouraged from making qualified mortgages, which would thwart Congress's goal of increasing incentives for creditors to make more stable, affordable loans.

32(b)(1)(iv) Credit Insurance and Debt Cancellation or Suspension Coverage

The Board proposes to revise § 226.32(b)(1)(iv) to reflect statutory changes under the Dodd-Frank Act. *See* TILA Section 103(aa)(4)(D). Specifically, proposed § 226.32(b)(1)(iv) includes in points and fees "[p]remiums or other charges payable at or before closing of the mortgage loan for any credit life, credit disability, credit unemployment, or credit property insurance, or any other life, accident, health, or loss-of-

[17] *See* Mortgage Reform and Anti-Predatory Lending Act, H. Rep. 111–94, p. 121 (May 4, 2009). An earlier version of the Dodd-Frank Act would have amended the statutory provision implemented by § 226.32(b)(1)(iii) to read as follows (added language italicized):

* * * [P]oints and fees shall include—

* * *

(C) each of the charges listed in section 106(e) (except an escrow for future payment of taxes), unless—

(i) the charge is reasonable;

(ii) the creditor receives no direct or indirect compensation*, except where applied to the charges set forth in section 106(e)(1) where a creditor may receive indirect compensation solely as a result of obtaining distributions of profits from an affiliated entity based on its ownership interest in compliance with section 8(c)(4) of the Real Estate Settlement Procedures Act of 1974;* and

(iii) the charge is paid to a third party unaffiliated with the creditor.

See id.

[18] Section 226.4(c)(7) implements TILA Section 106(e), which states: "The following items, *when charged in connection with any extension of credit secured by an interest in real property,* shall not be included in the computation of the finance charge with respect to that transaction: (1) Fees or premiums for title examination, title insurance, or similar purposes. (2) Fees for preparation of loan-related documents. (3) Escrows for future payments of taxes and insurance. (4) Fees for notarizing deeds and other documents. (5) Appraisal fees, including fees related to any pest infestation or flood hazard inspections conducted prior to closing. (6) Credit reports" (emphasis added). 15 U.S.C. 1605(e).

income insurance, or any payments directly or indirectly for any debt cancellation or suspension agreement or contract." Except for non-substantive changes in the ordering of the items listed, this provision mirrors the statutory language.

TILA's new points and fees provision regarding charges for credit insurance and debt cancellation and suspension coverage adds certain types of credit insurance-related products to the existing list of credit insurance products for which payments at or before closing must be considered points and fees in existing § 226.32(b)(1)(iv). Accordingly, proposed revisions to § 226.32(b)(1)(iv) add to the list of products the following new items: Credit disability, credit unemployment, or credit property insurance and debt suspension coverage. (Other life, accident, health, or loss-of-income insurance, or any payments directly or indirectly for any debt cancellation or suspension agreement or contract are included in the existing provision.) In a separate provision, however, the Dodd-Frank Act bans single-premium credit insurance and debt protection products of all the types listed above, except for credit unemployment insurance meeting certain conditions. *See* TILA Section 129C(d); 15 U.S.C. 1639c(d). The Board notes that the practical result of these combined amendments is that only single-premium credit unemployment insurance meeting certain conditions is permitted; therefore only single-premium credit unemployment insurance will be included in points and fees.[19]

The proposal revises current comment 32(b)(1)(iv)–1 to clarify that upfront charges for debt cancellation or suspension agreements or contracts are expressly included in points and fees. Another proposed revision clarifies that upfront credit insurance premiums and debt cancellation or suspension charges must be included in "points and fees" regardless of whether the insurance or coverage is optional or voluntary. The proposal adds new comment 32(b)(1)(iv)–2 to clarify that "credit property insurance" includes insurance against loss of or damage to personal property, such as a houseboat or manufactured home. The comment states that "credit property insurance" as used in § 226.32(b)(1)(iv) covers the creditor's security interest in the property. The comment explains that "credit property insurance" does not include homeowners insurance, which, unlike "credit property insurance," typically covers not only the dwelling but its contents, and designates the consumer, not the creditor, as the beneficiary.

The Board requests comment on the proposal to implement the statutory provision that includes upfront premiums and charges for credit insurance and debt cancellation and suspension coverage in the definition of "points and fees."

32(b)(1)(v) Prepayment Penalties That May be Charged on the Loan

Proposed § 226.32(b)(1)(v) includes in points and fees "the maximum prepayment penalty, as defined in § 226.43(b)(10), that may be charged or collected under the terms of the mortgage loan." This provision implements TILA Section 103(aa)(4)(E) and incorporates the statutory language, with the exception of minor non-substantive changes, such as that the proposed regulatory provision cross-references proposed § 226.43(b)(10) for the definition of "prepayment penalty." *See* section-by-section analysis of § 226.43(b)(10), below.

32(b)(1)(vi) Total Prepayment Penalties Incurred in a Refinance

Proposed § 226.32(b)(1)(vi) includes in points and fees "the total prepayment penalty, as defined in § 226.43(b)(10), incurred by the consumer if the mortgage loan is refinanced by the current holder of the existing mortgage loan, a servicer acting on behalf of the current holder, or an affiliate of either." This provision implements TILA Section 103(aa)(4)(F), which includes in points and fees prepayment penalties incurred by a consumer "if the mortgage loan refinances a previous loan made or currently held by the creditor refinancing the loan or an affiliate of the creditor." *See* 15 U.S.C. 1602(aa)(4)(F).

The Board believes that this statutory provision is intended in part to curtail the practice of "loan flipping," which involves a creditor refinancing an existing loan for financial gain due to prepayment penalties and other fees that a consumer must pay to refinance the loan—regardless of whether the refinance is beneficial to the consumer. The Board uses the phrases "current holder of the existing mortgage loan" and "servicer acting on behalf of the current holder" to describe the parties that refinance a loan subject to this provision because, as a practical matter, these are the entities that would refinance the loan and directly or indirectly gain from associated prepayment penalties. The Board also uses the phrase "an affiliate of the current holder" to describe a third party that refinances a loan subject to this provision to be consistent with the statute, which, as noted, applies to prepayment penalties incurred in connection with refinances by "the creditor * * * or an affiliate of the creditor."

The proposed regulatory provision also cross-references proposed § 226.43(b)(10) for the definition of "prepayment penalty." *See* section-by-section analysis of § 226.43(b)(10), below.

The Board requests comment on the proposal to incorporate into the definition of "points and fees" the prepayment penalty provisions of TILA Section 103(aa)(4)(E) and (F) and solicits comment in particular on whether additional guidance is needed to facilitate compliance with these provisions.

32(b)(2) Exclusion From "Points and Fees" of Compensation Paid to Certain Persons

The Board proposes new § 226.32(b)(2) to reflect statutory amendments under the Dodd-Frank Act. Current § 226.32(b)(2), defining "affiliate," is proposed to be re-numbered as § 226.32(b)(3). Proposed § 226.32(b)(2) is intended to exempt from "points and fees" compensation paid to certain persons expressly excluded from the meaning of "mortgage originator" under the Dodd-Frank Act.

Employees of retailers of manufactured homes. Specifically, proposed § 226.32(b)(2)(i) excludes from "points and fees" compensation paid to "an employee of a retailer of manufactured homes who does not take a residential mortgage loan application, offer or negotiate terms of a residential mortgage loan, or advise a consumer on loan terms (including rates, fees, and other costs) but who, for compensation or other monetary gain, or in expectation of compensation or other monetary gain, assists a consumer in obtaining or applying to obtain a residential mortgage loan." This proposed exemption is necessary to implement the revised definition of "points and fees" under TILA Section 103(aa)(4)(B) (quoted above), because the statutory definition of "mortgage originator" excludes "an employee of a retailer of manufactured homes" who, for compensation or other monetary gain, or in expectation of compensation or other monetary gain, prepares residential mortgage loan packages or collects information on behalf of a

[19] Public Law 111–203, 124 Stat. 1376, Title XIV, § 1414. The Board is not at this time proposing to implement the restrictions on single-premium credit insurance under the Dodd-Frank Act.

consumer with regard to a residential mortgage loan.[20]

Real estate brokers. Proposed § 226.32(b)(2)(ii) excludes from "points and fees" compensation paid to "a person that only performs real estate brokerage activities and is licensed or registered in accordance with applicable state law, unless such person is compensated by a creditor or loan originator, as defined in § 226.36(a)(1), or by any agent of the creditor or loan originator." This proposed exemption is necessary to implement the revised definition of "points and fees" under TILA Section 103(aa)(4)(B), because the statutory definition of "mortgage originator" contains a nearly identical exclusion.[21]

Proposed § 226.32(b)(2)(ii) uses the term "person" rather than the phrase "person or entity" used in the statute because "person" is defined in Regulation Z to mean "a natural person or an organization, including a corporation, partnership, proprietorship, association, cooperative, estate, trust, or government unit." Section 226.2(a)(22). The proposed regulation uses the term "loan originator" as defined in § 226.36(a)(1) rather than the terms "mortgage broker, or other mortgage originator" because the term "loan originator" under § 226.36(a)(1) includes a mortgage broker and is consistent with the statutory definition of "mortgage originator" in respects relevant to this provision. *See* section-by-section analysis of § 226.32(b)(1)(ii) for a discussion of consistencies between the meaning of "loan originator" in § 226.36(a)(1) and "mortgage originator" in the Dodd-Frank Act.

The term "loan originator" in § 226.36(a)(1) applies only to parties who arrange, negotiate, or obtain an extension of mortgage credit for a consumer in return for compensation or other monetary gain. Thus, a "loan originator" would not include a person engaged only in real estate brokerage activities. *See* 75 FR 58509, 58510 (Sept. 24, 2010). However, the exemption for real estate brokers from the meaning of "mortgage originator" is more precise in the Dodd-Frank Act. First, for the compensation of a real estate broker to be exempt, the broker must be licensed or registered under state law. In addition, the Dodd-Frank Act does not exclude real estate brokers from the definition of "mortgage originator" if they are compensated by the "lender, mortgage broker, or other mortgage originator" or an agent of any of these parties.

Servicers. Proposed § 226.32(b)(2)(ii) excludes from "points and fees" compensation paid to "a servicer or servicer employees, agents and contractors, including but not limited to those who offer or negotiate terms of a covered transaction for purposes of renegotiating, modifying, replacing and subordinating principal of existing mortgages where borrowers are behind in their payments, in default or have a reasonable likelihood of being in default or falling behind." This proposed exemption is necessary to implement the revised definition of "points and fees" under TILA Section 103(aa)(4)(B), because the statutory definition of "mortgage originator" excludes this compensation. TILA Section 103(cc)(2)(G).

The term "loan originator" (as defined in § 226.36(a)(1)), which is used in proposed § 226.32(b)(1)(ii) to describe the persons whose compensation must be counted in points and fees, does not apply to a loan servicer when the servicer modifies an existing loan on behalf of the current owner of the loan. *See* TILA Section 103(cc)(2)(G); 15 U.S.C. 1602(cc)(2)(G). *See also* comment 36(a)–1.iii. However, a "loan originator" under existing § 226.36(a)(1) includes a servicer who refinances a mortgage. *See* comment 36(a)–1.iii. A "refinancing" under § 226.36(a)(1) is defined as the satisfaction and replacement of an existing obligation subject to TILA by a new obligation by the same consumer. *See* § 226.20(a) and accompanying commentary.

By contrast, the exclusion for servicers under the statutory definition of "mortgage originator" appears to be broader than the definition of "loan originator" under existing § 226.36(a)(1). First, the exclusion expressly applies to "a servicer or servicer employees, agents and contractors." Second, the exclusion applies not only when these persons offer or negotiate terms of residential mortgage loan for purposes of modifying a loan, but also for purposes of "replacing and subordinating principal of existing mortgages where borrowers are behind in their payments, in default or have a reasonable likelihood of being in default or falling behind." TILA Section 103(cc)(2)(G).

The Board requests comment on the proposed exemptions from the definition of "points and fees" for compensation paid to certain persons not considered "mortgage originators" under the Dodd-Frank Act.

32(b)(3) Definition of "Affiliate"

Current § 226.32(b)(2) defining the term "affiliate" is re-numbered as § 226.32(b)(3) to accommodate the new proposed § 226.32(b)(2) regarding compensation for the purposes of points and fees. No substantive change is intended.

Section 226.34 Prohibited Acts or Practices in Connection With Credit Subject to § 226.32

34(a) Prohibited Acts or Practices for Loans Subject to § 226.32

34(a)(4) Repayment Ability

Currently, Regulation Z prohibits creditors making high-cost loans from extending credit without regard to a consumer's ability to repay. *See* § 226.34(a)(4). As discussed in greater detail in the section-by-section analysis to § 226.43 below, the Dodd-Frank Act now requires creditors to consider a consumer's ability to repay prior to making any residential mortgage loan, as defined in TILA Section 103(cc)(5). Proposed § 226.43 would implement this requirement and render unnecessary § 226.34(a)(4). The Board therefore proposes to remove § 226.34(a)(4) and its accompanying commentary. For ease of reading, the Board is not reprinting § 226.34(a)(4) and its accompanying commentary in this proposed rule.

Section 226.35 Prohibited Acts or Practices in Connection With Higher-Priced Mortgage Loans

Currently, § 226.35 prohibits certain acts or practices in connection with higher-priced mortgage loans. Section 226.35(a) provides the coverage test for

[20] Specifically, the statute excludes from the definition of "mortgage originator" "any person who is * * * (ii) an employee of a retailer of manufactured homes who is not described in clause (i) [takes a residential mortgage loan application] or (iii) [offers or negotiates terms of a residential mortgage loan] of subparagraph (A) and who does not advise a consumer on loan terms (including rates, fees, and other costs)." TILA Section 103(cc)(2)(A)(i), (cc)(2)(A)(iii) and (cc)(2)(A)(C); 15 U.S.C. 1602(cc)(2)(A) and (C). Thus, an employee of a retailer of manufactured homes is not considered a "mortgage originator" even if that person "for direct or indirect compensation or gain, or in the expectation of direct or indirect compensation or gain * * * assists a consumer in obtaining or applying for a residential mortgage loan." TILA Section 103(cc)(2)(A)(ii). The statute further defines "assists a consumer in obtaining or applying for a residential mortgage loan" to mean "among other things, advising on residential mortgage loan terms (including rates, fees, and other costs), preparing residential mortgage loan packages, or collecting information on behalf of the consumer with regard to a residential mortgage loan." TILA Section 103(cc)(4).

[21] The statutory definition of "mortgage originator" excludes "a person or entity that only performs real estate brokerage activities and is licensed or registered in accordance with applicable State law, unless such person or entity is compensated by a lender, a mortgage broker, or other mortgage originator or by any agent of such lender, mortgage broker, or other mortgage originator." TILA Section 103(cc)(2)(D).

higher-priced mortgage loans. Section 226.35(b)(1) contains the ability to repay requirement for higher-priced mortgage loans. Section 226.35(b)(2) sets forth restrictions on prepayment penalties for higher-priced mortgage loans. Section 226.35(b)(3) contains escrow rules for higher-priced mortgage loans. Section 226.35(b)(4) prohibits evasion of the higher-priced mortgage loan protections by structuring a transaction as open-end credit.

The proposed changes to Regulation Z in the 2011 Escrow Proposal and this proposal would render all of current § 226.35 unnecessary. The 2011 Escrow Proposal would adopt in proposed § 226.45(a) the coverage test for higher-priced mortgage loans in 226.35(a); would revise and adopt in § 226.45(b) the escrow requirements in § 226.35(b)(3); and would adopt in proposed § 226.45(d) the prohibition of evasion of the higher-priced mortgage loan protections by structuring a transaction as open-end credit, now in § 226.35(b)(4). This proposal, as discussed below, would supersede in § 226.43(a)–(f) the ability to repay requirement in § 226.35(b)(1), and would supersede in § 226.43(g) the prepayment penalty rules in § 226.34(b)(2). Accordingly, the Board proposes to remove and reserve § 226.35 and its accompanying commentary. For ease of reading, the Board is not reprinting § 226.35 and its accompanying commentary in this proposed rule.

Section 226.43 Minimum Standards for Transactions Secured by a Dwelling

TILA Sections 129C(a), (b), and (c) establish, for residential mortgage loans: (1) A requirement to consider a consumer's repayment ability; (2) alternative requirements for "qualified mortgages"; and (3) limits on prepayment penalties, respectively. The Board proposes to implement TILA Section 129C(a) through (c) in new § 226.43, as discussed in detail below.

43(a) Scope

Background

Section 1411 of the Dodd-Frank Act adds a new TILA Section 129C that requires creditors to determine a consumer's ability to repay a "residential mortgage loan." Section 1401 of the Act adds a new TILA Section 103(cc) that defines "residential mortgage loan" to mean, with some exceptions, any consumer credit transaction secured by a mortgage, deed of trust, or other equivalent consensual security interest on "a dwelling or on residential real property that includes a dwelling." TILA Section 103(v) defines "dwelling" to mean a residential structure or mobile home which contains one- to four-family housing units, or individual units of condominiums or cooperatives. Thus, a "residential mortgage loan" is a dwelling-secured consumer credit transaction, which can include: (1) A home purchase, refinancing, or home equity loan; (2) a loan secured by a first lien or a subordinate lien on a dwelling; (3) a loan secured by a dwelling that is a principal residence, second home, or vacation home (other than a timeshare residence); or (4) a loan secured by a one-to-four unit residence, condominium, cooperative, mobile home, or manufactured home.

However, the term "residential mortgage loan" does not include an open-end credit plan or an extension of credit relating to a timeshare plan, for purposes of the Act's repayment ability and prepayment penalty provisions under TILA Section 129C, among other provisions. *See* TILA Section 103(cc)(5); *see also* TILA Section 129C(i) (providing that timeshare transactions are not subject to TILA Section 129C). Further, the repayment ability provisions of TILA Section 129C(a) do not apply to reverse mortgages or temporary or "bridge" loans with a loan 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. *See* TILA Section 129C(a)(8). The repayment ability provisions of TILA Section 129C(a) also do not apply to consumer credit transactions secured by vacant land and not by a dwelling.

The scope of the 2008 HOEPA Final Rule differs from the scope of TILA Section 129C in three respects. First, as discussed above, the 2008 HOEPA Final Rule applies only to loans designated "higher-priced mortgage loans" or "high-cost mortgages" based on their APR or points and fees. Section 226.34(a)(4), 226.35(b)(1). By contrast, TILA Sections 129C(a) through (c) apply regardless of the residential mortgage loan's cost. Second, the 2008 HOEPA Final Rule is limited to loans secured by the consumer's principal dwelling. Section 226.32(a)(1), 226.35(a)(1). Finally, the 2008 HOEPA Final Rule does not exempt transactions secured by a consumer's interest in a timeshare plan.

The Board's Proposal

Proposed § 226.43(a) describes the scope of the requirement to determine a consumer's ability to repay a residential mortgage loan. Proposed § 226.43(a)(1) and (2) provide that the repayment ability provisions under proposed § 226.43 apply to consumer credit transactions secured by a dwelling, as defined in § 226.2(a)(19), except for (1) a home equity line of credit (HELOC) subject to § 226.5b, and (2) a mortgage transaction secured by a consumer's interest in a timeshare plan, as defined in 11 U.S.C. 101(53(D)). The exemptions under proposed § 226.43(a)(1) and (2) implement the exclusions from the definition of "residential mortgage loan" under TILA Section 103(cc)(5). Proposed § 226.43(a)(3) provides that the following transactions are exempt from coverage by proposed § 226.43(c) through (f): (1) A reverse mortgage subject to § 226.33; and (2) a temporary or "bridge loan" with a term of 12 months or less, such as a loan to finance the purchase of a new dwelling where the consumer plans to sell a current dwelling within 12 months or a loan to finance the initial construction of a dwelling.

As discussed in detail below, proposed § 226.43(c) and (d) implement repayment ability provisions and special rules for refinancings of "non-standard" mortgages into "standard" mortgages under TILA Section 129C(a). TILA Section 129C(a)(8) specifically provides that reverse mortgages and temporary or "bridge" loans with a term of 12 months or less are not subject to TILA Section 129C(a). The Board also proposes to apply this exception for purposes of alternative requirements for "qualified mortgages" and balloon-payment qualified mortgages pursuant to TILA Section 129C(b). Although TILA Section 129C(b) does not specifically exempt reverse mortgages or temporary or "bridge" loans with a term of 12 months or less from coverage by the alternative requirements for qualified mortgages, the Board believes the alternative requirements for qualified mortgages are relevant only if a transaction is subject to the repayment ability requirements. Accordingly, proposed § 226.43(a)(3) provides that reverse mortgages and temporary or "bridge" loans with a term of 12 months or less are not subject to the alternative requirements for qualified mortgages and balloon-payment qualified mortgages, under proposed § 226.43(e) or (f). Such transactions nevertheless are subject to the prepayment penalty restrictions under proposed § 226.43(g), discussed in detail below.

"*Residential mortgage loan.*" Proposed § 226.43(a) clarifies that requirements under proposed § 226.43 apply to any consumer credit transaction secured by a dwelling, as defined in § 226.2(a)(19), with certain exceptions discussed above. Proposed § 226.43(a) does not use the term "residential mortgage loan," for two reasons. First, the usefulness of the defined term "residential mortgage loan" is limited, because the coverage of provisions applicable to "residential mortgage loans" varies under different TILA provisions. For example, TILA Section 103(cc) excludes transactions secured by a consumer's interest in a timeshare transaction from the definition of "residential mortgage loan" for purposes of some, but not all, TILA provisions, and the Dodd-Frank Act provides or authorizes other specific exemptions from coverage by requirements for "residential mortgage loans." [22] Specifying which transactions are subject to and exempt from coverage by proposed § 226.43 in a scope provision thus would facilitate compliance better than using the defined term "residential mortgage loan."

Second, the term "residential mortgage loan" could be confused with the similar term "residential mortgage transaction," which means a transaction in which a mortgage or equivalent consensual security interest is created or retained against the consumer's dwelling to finance the acquisition or initial construction of the dwelling. *See* 15 U.S.C. 1602(w). The term "residential mortgage transaction," used in connection with rescission provisions under § 226.15 and 226.23, does not encompass such transactions as refinance transactions and home equity loans. Using the similar term "residential mortgage loan," which encompasses refinance transactions and home equity loans, could confuse creditors subject to proposed § 226.43.

Owner occupancy; consumer credit transaction. If a transaction is a dwelling-secured extension of consumer credit, proposed § 226.43 applies regardless of whether or not the consumer occupies the dwelling (unless an exception from coverage applies under proposed § 226.43(a)(1)-(3)). However, TILA and Regulation Z do not apply to credit extensions that are primarily for business purposes. 15 U.S.C. 1603(l); § 226.3(a)(1). Current guidance in comment 3(a)-2 clarifies the factors to be considered to determine whether a credit extension is business or consumer credit. Further, comment 3(a)-3 states that credit extended to acquire, improve, or maintain rental property that is not owner-occupied (that is, in which the owner does not expect to live for more than fourteen days during the coming year) is deemed to be for business purposes. Proposed comment 43(a)-1 clarifies that § 226.43 does not apply to an extension of credit primarily for a business, commercial, or agricultural purpose and cross-references the existing guidance on determining the primary purpose of an extension of credit in commentary on § 226.3.

Dwelling. TILA Section 129(cc) defines "residential mortgage loan" to mean a consumer credit transaction secured by a mortgage or equivalent consensual security interest "on a dwelling or on residential real property that includes a dwelling." Under TILA and Regulation Z, the term "dwelling" means a residential structure with one to four units, whether or not the structure is attached to real property, and includes a condominium or cooperative unit, mobile home, and trailer, if used as a residence. *See* 15 U.S.C. 1602(v); § 226.2(a)(19). To facilitate compliance by using consistent terminology throughout Regulation Z, the proposal uses the term "dwelling," as defined in § 226.2(a)(19), and not the phrase "residential real property that includes a dwelling." Proposed comment 43(a)-2 clarifies that, for purposes of § 226.43, the term "dwelling" includes any real property to which the residential structure is attached that also secures the covered transaction.

Renewable temporary or "bridge" loan. As discussed above, proposed § 226.43(a)(3)(ii) provides that a temporary or "bridge" loan with a term of 12 months or less, such as a loan to finance the purchase of a new dwelling where the consumer plans to sell a current dwelling within 12 months and a loan to finance the initial construction of a dwelling, is excluded from coverage by § 226.43(c) through (f). Proposed comment 43(a)-3 clarifies that, where a temporary or "bridge loan" is renewable, the loan term does not include any additional period of time that could result from a renewal provision. Proposed comment 43(a)-3 also provides an example where a construction loan has an initial loan term of 12 months but is renewable for another 12-month loan term. In that example, the loan is excluded from coverage by § 226.43(c) through (f), because the initial loan term is 12 months.

The Board recognizes the risk that determining coverage by ability-to-repay requirements for a renewable temporary or "bridge" loan with an initial loan term of 12 months or less based only on the initial loan term may allow circumvention of those requirements. The Board solicits comment on whether or not renewal loan terms should be considered under proposed § 226.43(a)(3)(ii). In particular, the Board requests comment on whether the proposed exclusion should be limited to certain types of temporary or "bridge" loans, such as loans to finance the initial construction of a dwelling, or should not apply for certain types of temporary or "bridge" loans, such as balloon-payment loans.

Interaction with RESPA. TILA Section 129C applies to dwelling-secured consumer credit transactions (other than those specifically excluded from coverage), even if they are not "federally related mortgage loans" subject to the Real Estate Settlement Procedures Act (RESPA). *See* 12 U.S.C. 2602(1); 24 CFR 3500.2(b), 3500.5. Consistent with TILA Section 129C, proposed § 226.43(a) applies broadly to consumer credit transactions secured by a dwelling (other than transactions excepted from coverage under § 226.43(a)(1)-(3)).

43(b) Definitions

Section § 226.43(b) provides several definitions for purposes of implementing the ability-to-repay, qualified mortgage, and prepayment penalty provisions under § 226.43(b) through (g), which implement TILA Sections 129C(a) through (c), as added by Sections 1411, 1412 and 1414 of the Dodd-Frank Act. These proposed defined terms are discussed in detail below.

43(b)(1) Covered Transaction

As discussed above in the section-by-section analysis of the scope provisions under proposed § 226.43(a), the Board proposes to apply § 226.43 to consumer credit transactions secured by a dwelling, other than (1) a HELOC; (2) a mortgage transaction secured by a consumer's interest in a timeshare plan; and (3) except for purposes of prepayment penalty requirements under proposed § 226.43(g), a reverse mortgage or a temporary or "bridge" loan with a loan term of 12 months or less. Accordingly, proposed § 226.43(b)(1) defines "covered transaction" to mean a consumer credit transaction that is secured by a dwelling, other than a transaction exempt from coverage under proposed § 226.43(a), for purposes of proposed § 226.43.

43(b)(2) Fully Amortizing Payment

TILA Section 129C(a)(3) requires, in part, that the creditor determine the consumer's ability to repay a loan "using a payment schedule that fully amortizes

[22] *See, e.g.,* TILA Section 129C(a)(8) (providing an exemption from repayment ability requirements for reverse mortgages and temporary or "bridge" loans with a term of 12 months or less); TILA Section 129D(d), (e) (authorizing an exemption from escrow requirements for certain creditors operating predominantly in rural or underserved areas and providing an exemption from escrow requirements for transactions secured by shares in a cooperative).

the loan over the term of the loan.” TILA Section 129C(a)(6)(D) provides that for purposes of making the repayment ability determination required under TILA Section 129C(a), the creditor must calculate the payment on the mortgage obligation assuming the loan is repaid in “monthly amortizing payments for principal and interest over the entire term of the loan.” The Board proposes to use the term “fully amortizing payment” to refer to periodic amortizing payments for principal and interest over the entire term of the loan, for simplicity.

Accordingly, consistent with statutory language, and with minor modifications for clarity, proposed § 226.43(b)(2) would define “fully amortizing payment” to mean a periodic payment of principal and interest that will fully repay the loan amount (as defined in proposed § 226.43(b)(5)) over the loan term (as defined in proposed § 226.43(b)(6)). This term appears primarily in proposed § 226.43(c)(5) and (d)(5), which provides, respectively, that (1) the creditor determine the consumer's ability to repay the covered transaction using the fully indexed rate or introductory rate, whichever is greater, and monthly, fully amortizing payments that are substantially equal; and (2) the creditor can refinance the consumer from a non-standard to standard mortgage if, among other things, the calculation of the payments for the non-standard and standard mortgage are based on monthly, fully amortizing payments that are substantially equal.

43(b)(3) Fully Indexed Rate

TILA Section 129C(a)(6)(D) requires that for purposes of making the repayment ability determination required under TILA Section 129C(a), the creditor must calculate the monthly payment on the mortgage obligation based on several assumptions, including that the monthly payment be calculated using the fully indexed rate at the time of loan closing, without considering the introductory rate. *See* TILA Section 129C(a)(6)(D)(iii). TILA Section 129C(a)(7) defines the term “fully indexed rate” as “the index rate prevailing on a residential mortgage loan at the time the loan is made plus the margin that will apply after the expiration of any introductory interest rates.” The term “fully indexed rate” appears in proposed § 226.43(c)(5), which implements TILA Section 129C(a)(6)(iii) and provides the payment calculation rules for covered transactions. The term also appears in § 226.43(d)(5), which provides special rules for creditors that refinance a consumer from a non-standard mortgage to a standard mortgage. These proposed provisions are discussed below.

The Board proposes § 226.43(b)(3) to define the term “fully indexed rate” as “the interest rate calculated using the index or formula at the time of consummation and the maximum margin that can apply at any time during the loan term.” This proposed definition is consistent with the statutory language of TILA Sections 129C(a)(6)(D)(iii) and 129C(a)(7), but revises certain statutory text to provide clarity.[23] First, for consistency with current Regulation Z and to facilitate compliance, the Board proposes to replace the phrases “at the time of the loan closing” in TILA Section 129C(a)(6)(D)(iii) and “at the time the loan is made” in TILA Section 129C(a)(7) with the phrase “at the time of consummation” for purposes of identifying the fully indexed rate. The Board interprets these statutory phrases to have the same meaning as the phrase “at the time of consummation.” *See* current § 226.2(a)(7), defining the term “consummation” for purposes of Regulation Z requirements as “the time that a consumer becomes contractually obligated on a credit transaction.”

Second, the Board interprets the reference to the margin that will apply “after the expiration of any introductory interest rates” as a reference to the maximum margin that can apply “at any time during the loan term,” for simplicity and consistency with TILA Section 103(a), discussed above. Referencing the entire loan term as the relevant period of time during which the creditor must identify the maximum margin that can occur under the loan makes the phrase “after the expiration of any introductory interest rates” unnecessary.

Third, the Board clarifies that the creditor should use the “maximum” margin that can apply when determining the fully indexed rate. Accordingly, the creditor would be required to take into account the largest margin that could apply under the terms of the legal obligation. The approach of using the maximum margin that can apply at any time during the loan term is consistent with the statutory language contained in TILA Section 103(aa), as amended by Section 1431 of the Dodd-Frank Act, which defines a high-cost mortgage. This statutory provision provides that, for purposes of the definition of a “high-cost mortgage,” for a mortgage with an interest rate that varies solely in accordance with an index, the annual percentage rate must be based on “the interest rate determined by adding the index rate in effect on the date of consummation of the transaction to the *maximum margin* permitted at any time during the loan agreement.” Furthermore, although the Board is not aware of any loan products used today that possess more than one margin that may apply over the loan term, the Board proposes this clarification to address the possibility that creditors may create products that permit different margins to take effect at different points throughout the loan term. The Board solicits comment on this approach.

The proposed definition of “fully indexed rate” is also generally consistent with the definition of fully-indexed rate, as used in the MDIA Interim Final Rule,[24] and with the Federal banking agencies' use of the term “fully indexed rate” in the 2006 Nontraditional Mortgage Guidance and 2007 Subprime Mortgage Statement.

Proposed comment 43(b)(3)–1 notes that in some adjustable-rate transactions, creditors may set an initial interest rate that is not determined by the index or formula used to make later interest rate adjustments. This comment would explain that, typically, this initial rate charged to consumers is lower than the rate would be if it were calculated using the index or formula at consummation (*i.e.,* a “discounted rate”); in some cases, this initial rate may be higher (*i.e.,* a “premium rate”). The comment would clarify that when determining the fully indexed rate where the initial interest rate is not determined using the index or formula for subsequent interest rate adjustments, the creditor must use the interest rate that would have applied had the creditor used such index or formula plus margin at the time of consummation. This comment would further clarify that this means, in determining the fully indexed rate, the creditor must *not* take into account any discounted or premium rate.

Proposed comment 43(b)(3)–1 provides an illustration of this principle. This comment first assumes an adjustable-rate transaction where the initial interest rate is not based on an index or formula, and is set at 5% for the first five years. The loan agreement provides that future interest rate

[23] *See* current 12 CFR § 226.17(c)(1) and comment 17(c)(1)–10, and 12 CFR § 226.18(s)(7)(vi), which identify the index in effect at consummation as the index value to be used in determining the fully indexed rate.

[24] *See* the 2010 MDIA Interim Final Rule, 75 FR 58470, 58484, Sept. 24, 2010, which defines fully indexed rate as “the interest rate calculated using the index value and margin”; *see also* 75 FR 81836, Dec. 29, 2010 (revising the MDIA Interim Final Rule.

adjustments will be calculated based on the London Interbank Offered Rate (LIBOR) plus a 3% margin. This comment explains that if the value of the LIBOR at consummation is 5%, the interest rate that would have been applied at consummation had the creditor based the initial rate on this index is 8% (5% plus 3% margin), and therefore, the fully indexed rate is 8%. To facilitate compliance, this comment would direct creditors to commentary that addresses payment calculations based on the greater of the fully indexed rate or "premium rate" for purposes of the repayment ability determination under § 226.43(c). *See* § 226.43(c)(5)(i) and comment 43(c)(5)(i)–2.

This proposed comment differs from guidance in current comment 17(c)(1)–10.i, which provides that in cases where the initial interest rate is not calculated using the index or formula for later rate adjustments, the creditor should disclose a composite annual percentage rate that reflects both the initial rate and the fully indexed rate. The Board believes the different approach taken in proposed comment 43(b)(3)–1 is required by the statutory language which specifies that, for purposes of determining the consumer's repayment ability, the fully indexed rate must be determined "without considering the introductory rate," and is the rate "that will apply after the expiration of any introductory interest rates." *See* TILA Sections 129C(a)(6)(D)(iii) and (7). Furthermore, the Board believes this approach is appropriate in the present case where the purpose of the statute is to determine whether the consumer can repay the loan according to its terms, including any potential increases in required payments. TILA Section 129B(a)(2); 15 U.S.C 1639b(a)(2).

The Board notes that the choice of which market index to use for later interest rate adjustments has become more germane for both creditors and consumers due to recent market developments. For example, in recent years consumers of adjustable-rate mortgages that are tied to a LIBOR index have paid more than they would have had their loans been tied to the U.S. Treasury index.[25] This divergence in index values is recent, and has not occurred historically. Given the increasing relevance of market indices, the Board solicits comment on whether loan products currently exist that base the interest rate on a specific index at consummation, but then base subsequent rate adjustments on a different index, and whether further guidance addressing how to calculate the fully indexed rate for such loan products is needed.

Proposed comment 43(b)(3)–2 further clarifies if the contract provides for a delay in the implementation of changes in an index value or formula, the creditor need not use that the index or formula in effect at consummation, and provides an illustrative example. This proposed comment is consistent with current guidance in Regulation Z regarding the use of the index value at the time of consummation where the contract provides for a delay. *See* comments 17(c)(1)–10.i and 18(s)(2)(iii)(C)–1, which addresses the fully indexed rate for purposes of disclosure requirements.

Proposed comment 43(b)(3)–3 explains that the creditor must determine the fully indexed rate without taking into account any periodic interest rate adjustment cap that may limit how quickly the fully indexed rate may be reached at any time during the loan term under the terms of the legal obligation. To illustrate, assume an adjustable-rate mortgage has an initial fixed rate of 5% for the first three years of the loan, 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 a lifetime maximum interest rate of 10%. The index value in effect at consummation is 4.5%. The fully indexed rate is 7.5% (4.5% plus 3%), regardless of the 2% annual interest rate adjustment cap that would limit when the fully indexed rate would take effect under the terms of the legal obligation.

The Board notes that guidance contained in proposed comment 43(b)(3)–3 also differs from guidance contained in current comment 17(c)(1)–10.iii, which addresses disclosure of the annual percentage rate on the TILA. Comment 17(c)(1)–10.iii states that when disclosing the annual percentage rate, creditors should give effect to periodic interest rate adjustment caps provided under the terms of the legal obligation (*i.e.,* to take into account any caps that would prevent the initial rate at the time of first adjustment from changing to the fully-indexed rate).

The Board believes the approach in proposed comment 43(b)(3)–3 is consistent with, and required by, the statutory language that states the fully indexed rate must be determined without considering any introductory rate and by using the margin that will apply after expiration of any introductory interest rates. *See* TILA Sections 129C(a)(6)(D)(iii) and (7). In addition, the Board notes the proposed definition of fully indexed rate, and its use in the proposed payment calculation rules, is designed to assess whether the consumer has the ability to repay the loan according to its terms. TILA Section 129B(a)(2); 15 U.S.C. 1639b(a)(2). This purpose differs from the principal purpose of disclosure requirements, which is to help ensure that consumers avoid the uninformed use of credit. TILA Section 102(a); 15 U.S.C. 1601(a). The Board believes disregarding the operation of adjustment caps in determining the payment for the covered transaction helps to ensure that the consumer can reasonably repay the loan once the interest rate adjusts. Furthermore, the guidance contained in proposed comment 43(b)(3)–3 is consistent with the Federal banking agencies' use of the term fully indexed rate in the 2006 Nontraditional Mortgage Guidance and 2007 Subprime Mortgage Statement.

Proposed comment 43(b)(3)–4 clarifies that when determining the fully indexed rate, a creditor may choose, in its sole discretion, to take into account the lifetime maximum interest rate provided under the terms of the legal obligation. This comment would explain, however, that where the creditor *chooses* to use the lifetime maximum interest rate, and the loan agreement provides a range for the maximum interest rate, the creditor *must* use the highest rate in that range as the maximum interest rate. To illustrate, assume an adjustable-rate mortgage has an initial fixed rate of 5% for the first three years of the loan, 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 a lifetime maximum interest rate of 7%. The index value in effect at consummation is 4.5%; the fully indexed rate is 7.5% (4.5% plus 3%). The creditor can choose to use the lifetime maximum interest rate of 7%, instead of the fully indexed rate of 7.5%, for purposes of this section.

The Board notes that the statutory construct of the payment calculation rules, and the requirement to calculate payments based on the fully indexed rate, apply to all loans that are subject to the ability-to-repay provisions, including loans that do not base the interest rate on an index and therefore, do not have a fully indexed rate. Specifically, the statute states that "[f]or purposes of making *any* determination under this *subsection,* a creditor shall calculate the monthly payment amount for principal and interest on *any*

[25] *See* Mark Schweitzer and Guhan Venkatu, *Adjustable-Rate Mortgages and the LIBOR Surprise,* at *http://www.clevelandfed.org/research/commentary/2009/012109.cfm.*

residential mortgage loan by assuming" several factors, including the fully indexed rate, as defined in the statute (emphasis added). *See* TILA Section 129C(a)(6)(D). The statutory definition of "residential mortgage loan" includes loans with variable-rate features that are not based on an index or formula, such as step-rate mortgages. *See* TILA Section 103(cc); *see also* proposed § 226.43(a), addressing the proposal's scope, and proposed § 226.43(b)(1), defining "covered transaction." However, because step-rate mortgages do not have a fully indexed rate, it is unclear what interest rate the creditor must assume when calculating payment amounts for purposes of determining the consumer's ability to repay the covered transaction.

As discussed above, the Board interprets the statutory requirement to use the "margin that can apply at any time after the expiration of any introductory interest rates" to mean that the creditor must use the "maximum margin that can apply at any time during the loan term" when determining the fully indexed rate. Accordingly, consistent with this approach, Board proposes to clarify in proposed comment 43(b)(3)–5 that where the interest rate offered in the loan is not based on, and does not vary with, an index or formula (*i.e.,* there is no fully indexed rate), the creditor must use the maximum interest rate that may apply at any time during the loan term. Proposed comment 43(b)(3)–5 provides illustrative examples for a step-rate and fixed-rate mortgage. This comment, for example, would assume a step-rate mortgage with an interest rate fixed at 6.5% for the first two years of the loan, 7% for the next three years, and 7.5% thereafter for the remainder of loan term. This comment would explain that, for purposes of determining the consumer's repayment ability, the creditor must use 7.5%, which is the maximum rate that may apply during the loan term. This comment would also provide an illustrative example for a fixed-rate mortgage.

The Board believes this approach is appropriate because the purpose of TILA Section 129C is to require creditors to assess whether the consumer can repay the loan according to its terms, including any potential increases in required payments. TILA Section 129B(a)(2), 15 U.S.C. 1639b(a)(2). Requiring creditors to use the maximum interest rate helps to ensure that consumers can repay the loan, without needing to refinance, for example. However, for the reasons discussed more fully below under proposed § 226.43(c)(5)(i), which discusses the general rule for payment calculations, the Board is equally concerned that by requiring creditors to use the maximum interest rate in a step-rate mortgage, the monthly payments used to determine the consumer's repayment ability will be overstated and may inappropriately restrict credit availability. For these reasons, the Board is soliciting comment on this approach, and whether the Board should exercise its authority under TILA Sections 105(a) and 129B(e) to provide an exception for step-rate mortgages. For example, should the Board require creditors to use the maximum interest rate that occurs in the first 5 or 10 years, or some other appropriate time horizon?

43(b)(4) Higher-Priced Covered Transaction

Proposed § 226.43(b)(4) defines "higher-priced covered transaction" to mean a covered transaction with an annual percentage rate that exceeds the average prime offer rate for a comparable transaction as of the date the interest rate is set by 1.5 or more percentage points for a first-lien covered transaction, or by 3.5 or more percentage points for a subordinate-lien covered transaction. The proposed definition of "higher-priced covered transaction" replicates the statutory language used in TILA Section 129C(a)(6)(D)(ii)(*I*) and (*II*), which grants the Board the authority to implement special payment calculation rules for a balloon loan that "has an annual percentage rate that does not exceed the average prime offer rate for a comparable transaction" by certain rate spreads. These rules appear in proposed § 226.43(c)(5)(ii)(A), and are discussed below.

The proposed definition of "higher-priced covered transaction" uses the term "average prime offer rate." To facilitate compliance and maintain consistency, the term "average prime offer rate" has the same meaning as in the Board's proposed § 226.45(a)(2)(ii). Proposed § 226.45(a)(2)(ii) defines "average prime offer rate" for purposes of determining the applicability of escrow requirements to "higher-priced mortgage loans" (as defined in proposed § 226.45(a)(1)), and states that the "average prime offer rate" means "an annual percentage rate that is derived from average interest rate, points, and other loan pricing terms currently offered to consumers by a representative sample of creditors for mortgage transactions that have low-risk pricing characteristics. The Board publishes average prime offer rates for a broad range of types of transactions in a table updated at least weekly as well as the methodology the Board uses to derive these rates." *See* 2011 Escrow Proposal, 76 FR 11598, Mar. 2, 2011, which implements new TILA Section 129D for escrow requirements. As discussed in the Board's 2011 Escrow Proposal, the proposed definition of "average prime offer rate" is identical to the definition of "average prime offer rate" in current § 226.35(a)(2), which the Board is proposing to remove, and consistent with the provisions of the Dodd-Frank Act, which generally codify the regulation's current definition of "average prime offer rate." *See* TILA Sections 129C(b)(2)(B) and 129D(b)(3).

However, the proposed definition of "higher-priced covered transaction" differs from the proposed definition of "higher-priced mortgage loan" included in the Board's 2011 Escrow Proposal in three respects: (1) To reflect statutory text, the proposed definition of "higher-priced covered transaction" would provide that the annual percentage rate, rather than the "transaction coverage rate," is the loan pricing metric to be used to determine whether a transaction is a higher-priced covered transaction; (2) consistent with the scope of the ability-to-repay provisions, "higher-priced covered transaction" would cover consumer credit transactions secured by a dwelling, and would not be limited to transactions secured by the consumer's principal dwelling; and (3) consistent with the statutory authority, the applicable thresholds in "higher-priced covered transaction" would not reflect the special, separate coverage threshold of 2.5 percentage points above the average prime offer rate for "jumbo" loans,[26] as provided for by the Board's 2011 Escrow Proposal and 2011 Jumbo Loan Escrow Final Rule. *See* 76 FR 11598, 11608–09, Mar. 2, 2011; 76 FR 11319, Mar. 2, 2011.[27] As a result of these differences, proposed commentary to "average prime offer rate" that clarifies the meaning of "comparable transaction" and "rate set" for purposes of higher-priced mortgage loans uses the

[26] A "jumbo" loan includes a loan whose original principal balance exceeds the current maximum loan balance for loans eligible for sale to Freddie Mac as of the date the transaction's rate is set. *See* TILA Section 129D(b)(3)(B), as enacted by Section 1461 of the Dodd-Frank Act; *see also* Board's March 2011 Jumbo Loan Escrow Final Rule, 76 FR 11319, 11324 (Mar. 2, 2011), which establishes the "jumbo" threshold in existing § 226.35(a)(1)(v).

[27] The Board's Jumbo Loan Escrow Final Rule added new § 226.35(a)(1)(v) to provide a separate, higher rate threshold for determining when the Board's escrow requirement applies to higher-priced mortgage loans that are "jumbo loans." The Board incorporated the identical provision regarding the "jumbo" threshold in its 2011 Escrow Proposal for the reasons stated therein, and in anticipation of the Board proposing to remove § 226.35 in its entirety, as discussed above. *See* proposed § 226.45(a)(1).

terms "transaction coverage rate," and refers to the consumer's principal dwelling. *See* proposed comments 45(a)(2)(ii)–2 and –3.[28]

To reduce the risk of confusion that may occur by cross-referencing to proposed commentary in the Board's 2011 Escrow Proposal that uses different terminology, the Board proposes commentary to proposed § 226.43(b)(4) to clarify the meaning of the terms "average prime offer rate," "comparable transaction" and "rate set," as those terms are used in the proposed definition of "higher-priced covered transaction."

Proposed comment 43(b)(4)–1 explains that the term "average prime offer rate" generally has the same meaning as in proposed § 226.45(a)(2)(ii), and would cross-reference proposed comments 45(a)(2)(ii)–1,–4, and –5, for further guidance on how to determine the average prime offer rate and for further explanation of the Board table. Proposed comment 43(b)(4)–2 states that the table of average prime offer rates published by the Board indicates how to identify the comparable transaction for a higher-priced covered transaction, as defined. Proposed comment 43(b)(4)–3 clarifies that a transaction's annual percentage rate is compared to the average prime offer rate as of the date the transaction's interest rate is set (or "locked") before consummation. This proposed comment also explains that sometimes a creditor sets the interest rate initially and then re-sets it at a different level before consummation, and clarify that in these cases, the creditor should use the last date the interest rate is set before consummation.

As discussed above, the Board is proposing to replace the term "annual percentage rate" with the "transaction coverage rate" for reasons stated in the Board's 2011 Escrow Proposal and 2010 Closed-End Proposal. *See* the Board's 2011 Escrow Proposal at 76 FR 11598, 11609, Mar. 2, 2011 and the Board's 2010 Closed-End Mortgage Proposal at 75 FR 58539, 58660–61, Sept. 24, 2010. As discussed more fully in these proposals, the Board recognized that the use of the annual percentage rate as the coverage metric for the higher-priced mortgage loan protections posed a risk of over inclusive coverage; the protections were intended to be limited to the subprime market. Specifically, the Board recognized that the term annual percentage rate would include a broader set of charges, causing the spread between the annual percentage rate and the average prime offer rate to widen.

Although the purpose differs, the Board similarly recognizes that the use of the term annual percentage rate in "higher-priced covered transaction" means that the scope of balloon loans that may exceed the applicable loan pricing thresholds will likely be greater. The Board is concerned that using an over inclusive metric to compare to the average prime offer rate may cover some prime loans and unnecessarily limit credit access to these loan products, contrary to statutory intent. For these reasons and also for consistency, the Board solicits comment on whether it should exercise its authority under Section TILA Sections 105(a) and 129B(e) to similarly replace "annual percentage rate" with "transaction coverage rate" as the loan pricing benchmark for higher-priced covered transactions. 15 U.S.C. 1604(a).

In addition, the Board notes that "jumbo" loans typically carry a premium interest rate to reflect the increased credit risk of such loans.[29] These loans are more likely to exceed the average prime offer rate coverage threshold and be considered higher-priced covered transactions under the thresholds established by TILA Section 129C(a)(6)(D)(ii). Accordingly, under this proposal creditors would have to underwrite such loans using the scheduled payments, including any balloon payment, regardless of the loan term. *See* proposed § 226.43(c)(5)(ii)(A)(*2*), discussed below. The Board is concerned that this approach may unnecessarily restrict credit access and choice in the "jumbo" balloon loan market. Thus, the Board also solicits comment on whether it should exercise its authority under TILA Sections 105(a) and 129B(e) to incorporate the special, separate coverage threshold of 2.5 percentage points in the proposed definition of "higher-priced covered transaction" to permit more "jumbo" balloon loans that have "prime" loan pricing to benefit from the special payment calculation rule set forth under proposed § 226.43(c)(5)(ii)(A)(*1*) for balloon loans. 15 U.S.C. 1604(a). *See* 76 FR 11598, 11608, Mar. 2 2011, which discusses the proposed "jumbo" threshold in relation to the proposed escrow requirements.

The Board similarly recognizes that loans secured by non-principal dwellings also generally carry a higher interest rate to reflect increased credit risk, regardless of loan size. As discussed above, the scope of this proposal extends to any dwelling-secured transaction, not just principal dwellings, and therefore second homes (*e.g.,* vacation homes) would be covered. A non-"jumbo" balloon loan for a vacation home, for example, would be subject to the same rate threshold that would apply to a non-"jumbo" loan secured by a principal dwelling. As a result, balloon loans secured by non-principal dwellings would be more likely to exceed the applicable rate threshold and be subject to the more stringent underwriting requirements discussed above. The Board is concerned that this approach may inappropriately restrict credit access in this market. Accordingly, the Board solicits comment, and supporting data, on whether it should exercise its authority under TILA Sections 105(a) and 129B(e) to incorporate a special, separate coverage threshold in the proposed definition of "higher-priced covered transaction" for loans secured by non-principal dwellings, and what rate threshold would be appropriate for such loans.

43(b)(5) Loan Amount

TILA Section 129C(a)(6)(D) requires that when the creditor makes the repayment ability determination under TILA Section 129C(a), it must calculate the monthly payment on the mortgage obligation based on several assumptions, including calculating the monthly payment assuming that "the loan proceeds are fully disbursed on the date of consummation of the loan." *See* TILA Section 129C(a)(6)(D)(i). This proposal replaces the phrase "loan proceeds are fully disbursed on the date of consummation of the loan" with the term "loan amount" for simplicity, and also to provide clarity.

Proposed § 226.43(b)(5) defines "loan amount" to mean the principal amount the consumer will borrow as reflected in the promissory note or loan contract. The Board believes that the loan contract or promissory note would accurately reflect all loan proceeds to be disbursed under the loan agreement to the consumer, including any proceeds the consumer uses to cover costs of the transaction. In addition, the term "loan amount" is generally used by industry and consumers to refer to the amount the consumer borrows and is obligated to repay under the loan agreement. The proposed term "loan amount" is consistent with the Board's 2009 Closed-End Mortgage Proposal, which proposed to define the term "loan amount" for purposes of disclosure. *See* 74 FR 43232, 43333, Aug. 26, 2009.

[28] 2011 Escrow Proposal, 76 FR 11598, 11626–11627, Mar. 2, 2011.

[29] *See, e.g.,* Shane M. Sherland, "The Jumbo-Conforming Spread: A Semiparametric Approach," Finance and Economics Discussion Series, Divisions of Research & Statistics and Monetary Affairs, Federal Reserve Board (2008–01).

The statute further requires that creditors assume that the loan amount is "fully disbursed on the date of consummation of the loan." *See* TILA Section 129C(a)(6)(D)(i). The Board recognizes that some loans do not disburse the entire loan amount to the consumer at consummation, but may, for example, provide for multiple disbursements up to an amount stated in the loan agreement. *See* current § 226.17(c)(6), discussing multiple-advance loans and comment 17(c)(6)–2 and –3, discussing construction-to-permanent financing loans. In these cases, the loan amount, as reflected in the promissory note or loan contract, does not accurately reflect the amount disbursed at consummation. Thus, to reflect the statutory requirement that the creditor assume the loan amount is fully disbursed at consummation, the Board would clarify that creditors must use the entire loan amount as reflected in the loan contract or promissory note, even where the loan amount is not fully disbursed at consummation. *See* proposed comment 43(b)(5)–1. This comment would provide an illustrative example. The example assumes the consumer enters into a loan agreement where the consumer is obligated to repay the creditor $200,000 over 15 years, but only $100,000 is disbursed at consummation and the remaining $100,000 will be disbursed during the year following consummation ($25,000 each quarter). This comment would explain that the creditor must use the loan amount of $200,000 even though the loan agreement provides that only $100,000 will be disbursed to the consumer at consummation. This comment would state that generally, creditors should rely on § 226.17(c)(6) and associated commentary regarding treatment of multiple-advance and construction loans that would be covered by this proposal (*i.e.,* loans with a term greater than 12 months). *See* proposed § 226.43(a)(3) discussing scope of coverage and term length. The Board solicits comment on whether further guidance regarding treatment of loans that provide for multiple disbursements, such as construction-to-permanent loans that are treated as as a single transaction, is needed.

The term "loan amount" appears in proposed § 226.43(b)(2), which defines "fully amortizing payment," and in proposed § 226.43(c)(5)(ii)(B), which implements the requirement under TILA Section 129C(a)(6)(D)(i) that the creditor assume that "the loan proceeds are fully disbursed on the date of consummation of the loan" when determining the consumer's ability to repay a loan. In addition, the term "loan amount" appears in proposed § 226.43(d)(5)(i)(C)(*2*) which implements TILA Section 129C(a)(6)(E) and provides the payment calculation for a non-standard mortgage with interest-only payments. The term "loan amount" also appears in proposed § 226.43(e)(2)(iv), which implements the requirement under TILA Sections 129C(b)(iv) and (v) that the creditor underwrite the loan using a periodic payment of principal and interest that will repay the loan to meet the definition of a qualified mortgage.

43(b)(6) Loan Term

TILA Section 129C(a)(3) requires that a creditor determine a consumer's repayment ability on a loan "using a payment schedule that fully amortizes the loan over the term of the loan." TILA Section 129C(a)(6)(D)(ii) also requires that for purposes of making the repayment ability determination under TILA Section 129C(a), the creditor calculate the monthly payment on the mortgage obligation assuming that the loan is repaid "over the entire term of the loan with no balloon payment." In addition, TILA Section 129C(b)(2)(A)(iv) and (v) require that a creditor underwrite the loan using "a payment schedule that fully amortizes the loan over the loan term" to meet the definition of a qualified mortgage. The Dodd-Frank Act does not define the term "loan term."

This proposal refers to the term of the loan as the "loan term," as defined, for simplicity. Proposed § 226.43(b)(6) provides that the "loan term" means the period of time to repay the obligation in full. This proposed definition is consistent with the proposed definition of "loan term" for disclosure purposes in the Board's 2009 Closed-End Mortgage Proposal. *See* 74 FR 43232, 43333, Aug. 26, 2009. This term primarily appears in proposed § 226.43(c)(5)(i), which implements TILA Section 129(a)(6)(D)(ii) and requires creditors to determine a consumer's ability to repay the loan based on fully amortizing payments. *See* proposed § 226.43(b)(2), which defines "fully amortizing payments" as periodic payments that will fully repay the loan amount over the loan term. "Loan term" also is used in proposed § 226.43(e)(2)(iv), which implements TILA Section 129C(b)(2)(iv) and (v) and requires creditors to underwrite the loan using the periodic payment of principal and interest that will repay the loan over the loan term to meet the definition of a qualified mortgage.

Proposed comment 43(b)(6)–1 clarifies that the loan term is the period of time it takes to repay the loan amount in full. For example, a loan with an initial discounted rate that is fixed for the first two years, and that adjusts periodically for the next 28 years has a loan term of 30 years, which is the amortization period on which the periodic amortizing payments are based.

43(b)(7) Maximum Loan Amount

Proposed § 226.43(b)(7) defines "maximum loan amount" to mean the loan amount plus any increase in principal balance that results from negative amortization (defined in current § 226.18(s)(7)(v)), based on the terms of the legal obligation assuming that: (1) The consumer makes only the minimum periodic payments for the maximum possible time, until the consumer must begin making fully amortizing payments; and (2) the maximum interest rate is reached at the earliest possible time. The term "maximum loan amount" implements, in part, TILA Section 129(a)(6)(C), which states that when making the payment calculation for loans with negative amortization, "a creditor shall also take into consideration any balance increase that may accrue from any negative amortization provision."

Loans with negative amortization typically permit consumers to make payments that cover only part of the interest accrued each month, and none of the principal. The unpaid but accrued interest is added to the principal balance, causing negative equity (*i.e.,* negative amortization). This accrued but unpaid interest can be significant if the loan terms do not provide for any periodic interest rate adjustment caps, thereby permitting the accrual interest rate to quickly escalate to the lifetime maximum interest rate. As a result of these loan features, consumers of loans with negative amortization are more likely to encounter payment shock once fully amortizing payments are required. For these reasons, the Board believes it is appropriate to interpret the phrase "*any* balance increase that may accrue" as requiring the creditor to account for the greatest potential increase in the principal balance that could occur under in a loan with negative amortization. *See* TILA Section 129(a)(6)(C). The Board also believes this interpretation is consistent with the overall statutory construct that requires creditors to determine whether the consumer is able to manage payments that may be required at any time during the loan term, especially where payments can escalate significantly in amount. The proposed definition of "maximum loan amount" is also consistent with the approach in the

MDIA Interim Final Rule,[30] which addresses disclosure requirements for negative amortization loans, and the 2006 Nontraditional Mortgage Guidance, which provides guidance to creditors regarding underwriting negative amortization loans.[31]

The term "maximum loan amount" is used in proposed § 226.43(c)(5)(ii)(C), which implements the statutory requirements under new TILA Section 129C(a)(6)(C) and (D) regarding payment calculations for negative amortization loans. *See* proposed § 226.43(c)(5)(ii)(C), which discusses more fully the scope of loans covered by the term "negative amortization loan," as defined in current § 226.18(s)(7)(v). The term also appears in proposed § 226.43(d), which addresses the exception to the repayment ability provision for the refinancing of a non-standard mortgage.

Proposed comment 43(b)(7)–1 clarifies that in determining the maximum loan amount, the creditor must assume that the consumer makes the minimum periodic payment permitted under the loan agreement for as long as possible, until the consumer must begin making fully amortizing payments, and that the interest rate rises as quickly as possible after consummation under the terms of the legal obligation. The proposed comment further clarifies that creditors must assume the consumer makes the minimum periodic payment until any negative amortization cap is reached or until the period permitting minimum periodic payments expires, whichever occurs first. This comment would cross-reference proposed § 226.43(b)(5) and § 226.18(s)(7)(v) for the meaning of the terms "loan amount" and "negative amortization loan," respectively.

Proposed comment 43(b)(7)–2 provides further guidance to creditors regarding the assumed interest rate to use when determining the maximum loan amount. This comment would explain that when calculating the maximum loan amount for an adjustable-rate mortgage that is a negative amortization loan, the creditor must assume that the interest rate will increase as rapidly as possible after consummation, taking into account any periodic interest rate adjustment caps provided in the loan agreement. This comment would further explain that for an adjustable-rate mortgage with a lifetime maximum interest rate but no periodic interest rate adjustment cap, the creditor must assume the interest rate increases to the maximum lifetime interest rate at the first adjustment.

Proposed comment 43(b)(7)–3 provides examples illustrating the application of the proposed definition of "maximum loan amount" for a negative amortization loan that is an adjustable-rate mortgage and for a fixed-rate, graduated payment mortgage. For example, proposed comment 43(b)(7)–3.i assumes an adjustable-rate mortgage in the amount of $200,000 with a 30-year loan term. The loan agreement provides that the consumer can make minimum monthly payments that cover only part of the interest accrued each month until the principal balance reaches 115% of its original balance (*i.e.,* a negative amortization cap of 115%) or for the first five years of the loan (60 monthly payments), whichever occurs first. The introductory interest rate at consummation is 1.5%. One month after consummation, the interest rate adjusts and will adjust monthly thereafter based on the specified index plus a margin of 3.5%. The maximum lifetime interest rate is 10.5%; there are no other periodic interest rate adjustment caps that limit how quickly the maximum lifetime rate may be reached. The minimum monthly payment for the first year is based on the initial interest rate of 1.5%. After that, the minimum monthly payment adjusts annually, but may increase by no more than 7.5% over the previous year's payment. The minimum monthly payment is $690 in the first year, $740 in the second year, and $798 in the first part of the third year. *See* proposed comment 43(b)(7)–3.i(*A*).

This comment then states that to determine the maximum loan amount, creditors should assume that the interest rate increases to the maximum lifetime interest rate of 10.5% at the first adjustment (*i.e.,* the second month) and accrues at that rate until the loan is recast. This proposed comment further assumes the consumer makes the minimum monthly payments as scheduled, which are capped at 7.5% from year-to-year. This comment would explain that as a result, the consumer's minimum monthly payments are less than the interest accrued each month, resulting in negative amortization (*i.e.,* the accrued but unpaid interest is added to the principal balance).

This comment concludes that on the basis of these assumptions (that the consumer makes the minimum monthly payments for as long as possible and that the maximum interest rate of 10.5% is reached at the first rate adjustment (*i.e.,* the second month)), the negative amortization cap of 115% is reached on the due date of the 27th monthly payment and the loan is recast. The maximum loan amount as of the due date of the 27th monthly payment is $229,243. *See* proposed comment 43(b)(7)–3.i(*B*).

43(b)(8) Mortgage-Related Obligations

The Board proposes to use the term "mortgage-related obligations" to refer to "all applicable taxes, insurance (including mortgage guarantee insurance), and assessments" for purposes of TILA Sections 129C(a)(1) through (3) and (b)(2)(A)(iv) and (v). TILA Sections 129C(a)(1) and (2) require that a creditor determine a consumer's ability to repay the loan "according to [the loan's] terms, and all applicable taxes, insurance (including mortgage guarantee insurance), and assessments." TILA Section 129C(a)(3) further states that the creditor must consider the consumer's debt-to-income ratio after allowing for "non-mortgage debt and mortgage-related obligations." In addition, TILA Sections 129C(b)(2)(A)(iv) and (v) provide that to meet the qualified mortgage standard, the creditor must underwrite the loan "tak[ing] into account all applicable taxes, insurance, and assessments[.]" The Dodd-Frank Act does not define the term "mortgage-related obligations." However, these statutory requirements are substantially similar to current § 226.34(a)(4) of the Board's 2008 HOEPA Final Rule, which requires the creditor to consider mortgage-related obligations when determining the consumer's repayment ability on a loan. Current § 226.34(a)(4)(i) defines "mortgage-related obligations" as expected property taxes, premiums for mortgage-related insurance required by the creditor as set forth in current § 226.35(b)(3)(i), and similar expenses, such as homeowners' association dues and condominium or cooperative fees. *See* comment 34(a)(4)(i)–1.

Proposed § 226.43(b)(8) defines the term "mortgage-related obligations" to mean property taxes; mortgage-related insurance premiums required by the creditor as set forth in proposed § 226.45(b)(1); homeowner's association, condominium, and cooperative fees; ground rent or leasehold payments; and special assessments. Proposed § 226.43(b)(8) is consistent with TILA Sections 129C(a)(1)–(3) and 129C(b)(2)(A)(iv) and (v), with modifications to the statutory language to provide greater clarity to creditors regarding what items are included in the phrase "taxes, insurance (including mortgage guarantee insurance), and assessments." Based on outreach, the Board believes greater specificity in

[30] *See* 12 CFR 226.18(s)(2)(ii) and comment 18(s)(2)(ii)–2, which discusses assumptions made for the interest rates in adjustable-rate mortgages that are negative amortization loans.

[31] *See* 2006 Nontraditional Mortgage Guidance at 58614, n.7.

defining the term "mortgage-related obligations" would address concerns that some creditors may have difficulty determining which items should be included as mortgage-related obligations when determining the total monthly debt a consumer will owe in connection with a loan. The proposed term would also track the current meaning of the term mortgage-related obligations in current § 226.34(a)(4)(i) and comment 34(a)(4)(i)–1, which the Board is proposing to remove, with several clarifications.

The Board proposes to define the term "mortgage-related obligations" with three clarifications. First, consistent with current underwriting practices, the proposed definition of "mortgage-related obligations" would include reference to ground rent or leasehold payments, which are payments made to the land owner or leaseholder for use of the land. Second, the proposed term would include reference to "special assessments." Proposed comment 43(b)(8)–1 clarifies that special assessments include, for example, assessments that are imposed on the consumer at or before consummation, such as a one-time homeowners' association fee that will not be paid by the consumer in full at or before consummation. Third, the term "mortgage-related obligations" would reference proposed § 226.45(b)(1) to include mortgage-related insurance premiums required by the creditor, such as insurance against loss of or damage to property, or against liability arising out of the ownership or use of the property, or insurance protecting the creditor against the consumer's default or other credit loss. Proposed § 226.45(b)(1) parallels current § 226.35(b)(3)(i), which the Board is proposing to remove. *See* 76 FR 11598, 11610, Mar. 2, 2011 for discussion of proposed § 226.45(b)(1). The Board solicits comment on how to address any issues that may arise in connection with homeowners' association transfer fees and costs associated with loans for energy-efficient improvement.

Proposed comment 43(b)(8)–1 further clarifies that mortgage-related obligations include expected property taxes and premiums for mortgage-related insurance required by the creditor as set forth in § 226.45(b)(1), such as insurance against loss of or damage to property or against liability arising out of the ownership or use of the property, and insurance protecting the creditor against the consumer's default or other credit loss. This comment would explain that the creditor need not include premiums for mortgage-related insurance that it does not require, such as earthquake insurance or credit insurance, or fees for optional debt suspension and debt cancellation agreements. To facilitate compliance, this comment would refer to commentary associated with proposed § 226.43(c)(2)(v), which discusses the requirement to take into account any mortgage-related obligations for purposes of the repayment ability determination required under proposed § 226.43(b)(2).

The term "mortgage-related obligations" appears in proposed § 226.43(c)(2)(v), which implements new TILA Sections 129C(a)(1) through (3) and requires that the creditor determine a consumer's ability to repay a covered transaction, taking into account mortgage-related obligations. The term also appears in proposed § 226.43(e)(2)(iv), which implements new TILA Section 129C(b)(2)(A)(iv) and (v) and requires that the creditor underwrite a loan taking into account mortgage-related obligations to meet the qualified mortgage definition. Proposed § 226.43(c) and (e) are discussed in further detail below.

43(b)(9) Points and Fees

For ease of reference, proposed § 226.43(b)(9) states that the term "points and fees" has the same meaning as in § 226.32(b)(1).

43(b)(10) Prepayment Penalty

TILA Section 129C(c), as added by Section 1414 of the Dodd-Frank Act, limits the transactions that may include a "prepayment penalty," the period during which a prepayment penalty may be imposed, and the maximum amount of a prepayment penalty. TILA Section 129C(c) also requires creditors to offer a consumer a covered transaction without a prepayment penalty if they offer the consumer a covered transaction with a prepayment penalty. Qualified mortgages are subject to additional limitations on prepayment penalties, pursuant to points and fees limitations under Section 1412 of the Act. TILA Section 129C(b)(2)(A)(viii) limits the points and fees that may be charged for a qualified mortgage to three percent of the total loan amount. TILA Section 103(aa)(4)(E) and (F), as added by Section 1431(c) of the Dodd-Frank Act, define "points and fees" to include (1) the maximum prepayment fees and penalties that may be charged under the terms of the covered transaction; and (2) all prepayment fees or penalties that are incurred by the consumer if the loan refinances a previous loan made or currently held by the same creditor or an affiliate of the creditor.

TILA establishes certain disclosure requirements for transactions for which a penalty is imposed upon prepayment but does not define the term "prepayment penalty." TILA Section 128(a)(11) requires that the transaction-specific disclosures for closed-end consumer credit transactions disclose a "penalty" imposed upon prepayment in full of a closed-end transaction, without using the term "prepayment penalty." 15 U.S.C. 1638(a)(11).[32] Current commentary on § 226.18(k)(1), which implements TILA Section 128(a)(11), clarifies that a "penalty" imposed upon prepayment in full is a charge assessed solely because of the prepayment of an obligation and includes, for example, "interest" charges for any period after prepayment in full is made and a minimum finance charge.[33] *See* comment 18(k)–1. The Board's 2009 Closed-End Mortgage Proposal clarifies that prepayment penalties include origination or other charges that a creditor waives unless the consumer prepays, but do not include fees imposed for preparing a payoff statement, among other clarifications. *See* 74 FR 43232, 43413, Aug. 29, 2009. Also, the Board's 2010 Mortgage Proposal clarifies that prepayment penalties include "interest" charges after prepayment in full even if the charge results from the interest accrual amortization method used on the transaction. *See* 75 FR 58539, 58756, Sept. 24, 2010.

Proposed § 226.43(b)(10) defines "prepayment penalty" as a charge imposed for paying all or part of a covered transaction's principal before the date on which the principal is due. Also, proposed § 226.43(b)(10)(i) provides the following examples of "prepayment penalties" for purposes of § 226.43: (1) A charge determined by treating the loan balance as outstanding for a period of time after prepayment in full and applying the interest rate to such "balance," even if the charge results from the interest accrual amortization method used for other payments in the transaction; and (2) a fee, such as a loan closing cost, that is

[32] Also, TILA Section 128(a)(12) requires that the transaction-specific disclosures state that the consumer should refer to the appropriate contract document for information regarding certain loan terms or features, including "prepayment * * * penalties." 15 U.S.C. 1638(a)(12). In addition, TILA Section 129(c) limits the circumstances in which a high-cost mortgage may include a "prepayment penalty." 15 U.S.C. 1639(c).

[33] Prepayment penalty disclosure requirements under § 226.18(k) apply to closed-end mortgage and non-mortgage transactions. In the 2009 Closed-End Mortgage Proposal, the Board proposed to establish a new § 226.38(a)(5) for disclosure of prepayment penalties specifically for closed-end mortgage transactions.

waived unless the consumer prepays the covered transaction. Proposed comment 43(b)(10)(A)–1 clarifies that "interest accrual amortization" refers to the method used to determine the amount of interest due for each period (for example, a month) in a transaction's term. The proposed comment also provides an example where a prepayment penalty of $1,000 is imposed because a full month's interest of $3,000 is charged even though only $2,000 in interest was earned in the month during which the consumer prepaid. Proposed § 226.43(b)(10)(ii) provides that a prepayment penalty does not include fees imposed for preparing and providing documents when a loan is paid in full, whether or not the loan is prepaid, such as a loan payoff statement, a reconveyance document, or another document releasing the creditor's security interest in the dwelling that secures the loan.

Proposed § 226.43(b)(10) uses language substantially similar to the language used in TILA Section 129C(c), but proposed § 226.43(b)(10) refers to charges for payment "before the date on which the principal is due" rather than "after the loan is consummated," for clarity. Proposed § 226.43(b)(10)(i) and (ii) are substantially similar to the current guidance on prepayment penalties in comment 18(k)–1 and in proposed § 226.38(a)(5) under the Board's 2009 Closed-End Mortgage Proposal and 2010 Mortgage Proposal, discussed above. However, proposed § 226.43(b)(10) omits commentary providing: (1) Examples of prepayment penalties include a minimum finance charge because such charges typically are imposed with open-end, rather than closed-end, transactions; and (2) examples of prepayment penalties do not include loan guarantee fees because loan guarantee fees are not charges imposed for paying all or part of a loan's principal before the date on which the principal is due. *See* comment 18(k)(1)–1. The term "prepayment penalty" appears in the "points and fees" definition in proposed § 226.32(b)(1)(v) and (vi) and in the requirements for prepayment penalties in § 226.43(g).

The Board recognizes that the effect of including particular types of charges in the proposed definition of a "prepayment penalty" is to apply the limitations on prepayment penalties under TILA Section 129C(c) to those types of charges, which in turn could limit the availability of credit. In particular, if "prepayment penalty" is defined to include a provision that requires the consumer to pay "interest" for a period after prepayment in full, or a provision that waives fees unless the consumer prepays, pursuant to TILA Section 129C(c) a covered transaction may not include such provisions unless the transaction: (1) Has an APR that cannot increase, (2) is a qualified mortgage, and (3) is not a higher-priced mortgage loan, as discussed in detail in the section-by-section analysis of proposed § 226.43(g). Also, the amount of the "interest" charged after prepayment, or the amount of fees waived unless the consumer prepays, would be limited. Finally, the creditor would have to offer an alternative covered transaction for which "interest" will not be charged after prepayment or for which fees are waived even if the consumer prepays (although under the Board's proposal the alternative covered transaction could have a different interest rate). Thus, the Board solicits comment on whether or not it is appropriate to include "interest" charged for a period after prepayment, or fees waived unless the consumer prepays, in the definition of "prepayment penalty" under proposed § 226.43(b)(10). Specifically, the Board requests comment on the possible effects of including those charges on the availability of particular types of covered transactions.

43(b)(11) Recast

Proposed § 226.43(b)(11) defines the term "recast," which is used in two paragraphs of proposed § 226.43: (1) Proposed § 226.43(c)(5)(ii) regarding certain required payment calculations that creditors must consider in determining a consumer's ability to repay a covered transaction; and (2) proposed § 226.43(d) regarding payment calculations required for refinancings that are exempt from the ability-to-repay requirements in § 226.43(c).

Specifically, § 226.43(b)(11) defines the term "recast" as follows: (1) For an adjustable-rate mortgage, as defined in § 226.18(s)(7)(i),[34] the expiration of the period during which payments based on the introductory interest rate are permitted under the terms of the legal obligation; (2) for an interest-only loan, as defined in § 226.18(s)(7)(iv),[35] 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 § 226.18(s)(7)(v),[36] the expiration of the period during which negatively amortizing payments are permitted under the terms of the legal obligation.

Proposed comment 43(b)(11)–1 explains that the date on which the "recast" occurs is the due date of the last monthly payment based on the introductory fixed rate, the interest-only payment, or the negatively amortizing payment, as applicable. Proposed comment 43(b)(11)–1 also provides an illustration of this rule for a loan in an amount of $200,000 with a 30-year loan term, where the loan agreement provides for a fixed interest rate and permits interest-only payments for the first five years of the loan (60 months). Under proposed § 226.43(b)(11), the loan is "recast" on the due date of the 60th monthly payment. Thus, the term of the loan remaining as of the date the loan is recast is 25 years (300 months).

The statute uses the term "reset" to suggest the time at which the terms of a mortgage loan are adjusted, resulting in higher required payments. For example, TILA Section 129C(a)(6)(E)(ii) states that a creditor that refinances a loan may, under certain conditions, "consider if the extension of new credit would prevent a likely default should the original mortgage reset and give such concerns a higher priority as an acceptable underwriting practice." 15 U.S.C. 1639c(a)(6)(E)(ii). The legislative history further indicates that, for adjustable-rate mortgages with low, fixed introductory rates, Congress understood the term "reset" to mean the time at which the low teaser rates converted to fully indexed rates, resulting in "significantly higher monthly payments for homeowners." [37]

Outreach participants indicated that the term "recast" is typically used to reference the time at which fully amortizing payments are required for interest-only and negative amortization loans and that the term "reset" is more frequently used to indicate the time at which adjustable-rate mortgages with an introductory fixed rate convert to a variable rate. For simplicity and clarity, however, the Board proposes to use the term "recast" to cover the conversion to less favorable terms and higher

[34] "The term 'adjustable-rate mortgage' means a transaction secured by real property or a dwelling for which the annual percentage rate may increase after consummation." 12 CFR 226.18(s)(7)(i).

[35] "The term 'interest-only' means that, under the terms of the legal obligation, one or more of the periodic payments may be applied solely to accrued interest and not to loan principal; an 'interest-only loan' is a loan that permits interest-only payments." 12 CFR 226.18(s)(7)(iv).

[36] "[T]he term 'negative amortization' means payment of periodic payments that will result in an increase in the principal balance under the terms of the legal obligation; the term 'negative amortization loan' means a loan that permits payments resulting in negative amortization, other than a reverse mortgage subject to section 226.33." 12 CFR 226.18(s)(7)(v).

[37] *See* U.S. House of Reps., Comm. on Fin. Services, Report on H.R. 1728, Mortgage Reform and Anti-Predatory Lending Act, No. 111–94, 52 (May 4, 2009).

payments not only for interest-only loans and negative amortization loans but also for adjustable-rate mortgages.

The Board solicits comment on the proposed definition of "recast" for purposes of proposed § 226.43(c) and (d).

43(b)(12) Simultaneous Loan

The Board proposes to use the term "simultaneous loan" to refer to loans that are subject to TILA Section 129C(a)(2), which states that "if a creditor knows, or has reason to know, that 1 or more residential mortgage loans secured by the same dwelling will be made to the same consumer, the creditor shall make a reasonable and good faith determination, based on verified and documented information, that the consumer has a reasonable ability to repay the combined payments of all loans on the same dwelling according to the terms of those loans and all applicable taxes, insurance (including mortgage guarantee insurance), and assessments." TILA Section 129C(a)(2) uses the term "residential mortgage loan," which is defined in TILA Section 103(cc)(5) as excluding home equity lines of credit (HELOCs) for purposes of TILA Section 129C. *See* proposed § 226.43(a), discussing the scope of the ability-to-repay provisions. Thus, TILA Section 129C(a)(2) does not require a creditor to consider a simultaneous HELOC when determining a consumer's repayment ability on the covered transaction.

By contrast, § 226.34(a)(4) of the Board's 2008 HOEPA Final Rule requires the creditor to consider the consumer's current obligations when making its repayment ability determination. Current comment 34(a)(4)–3 clarifies the meaning of the term "current obligations," and provides that it includes other dwelling-secured credit obligations undertaken prior to or at consummation of the transaction subject to § 226.34(a)(4) of which the creditor has knowledge. This comment does not distinguish between closed-end and open-end credit transactions for purposes of "other dwelling-secured obligations." Accordingly, under current comment 34(a)(4)–3 the creditor must consider in the repayment ability assessment a HELOC of which it has knowledge if the HELOC will be undertaken at or before consummation and will be secured by the same dwelling that secures the transaction.

Proposed § 226.43(b)(12) would define the term "simultaneous loan" to refer to other loans that are secured by the same dwelling and made to the same consumer at or before consummation of the covered transaction. The term would include HELOCs as well as closed-end mortgages for purposes of TILA Section 129C(a)(2). The Board believes TILA Section 129C(a)(2) is meant to help ensure that creditors account for the increased risk of consumer delinquency or default on the covered transaction where more than one loan secured by the same dwelling is originated concurrently, and therefore requires creditors to consider the combined payments on such loans. The Board believes this increased risk is present whether the other mortgage obligation is a closed-end credit transaction or a HELOC.

The Board proposes to broaden the scope of TILA Section 129C(a)(2) to include HELOCs, and accordingly proposes to define the term "simultaneous loan" to include HELOCs, using its authority under TILA Section 105(a). 15 U.S.C. 1604(a). TILA Section 105(a), as amended by Section 1100A of the Dodd-Frank Act, authorizes the Board to prescribe regulations to carry out the purposes of TILA and Regulation Z, to prevent circumvention or evasion, or to facilitate compliance. 15 U.S.C. 1604(a). The inclusion of HELOCs is further supported by the Board's authority under TILA Section 129B(e) to condition terms, acts or practices relating to residential mortgage loans that the Board finds necessary or proper to effectuate the purposes of TILA. 15 U.S.C. 1639b(e). One purpose of the statute is set forth in TILA Section 129B(a)(2), which states that "[i]t is the purpose[] of * * * [S]ection 129C to assure that consumers are offered and receive residential mortgage loans on terms that reasonably reflect their ability to repay the loans." 15 U.S.C. 1639b. For the reasons stated below, the Board believes requiring creditors to consider simultaneous loans that are HELOCs for purposes of TILA Section 129C(a)(2) would help to ensure that consumers are offered, and receive, loans on terms that reasonably reflect their ability to repay.

First, the Board is proposing in § 226.43(c)(2)(vi) that the creditor must consider current debt obligations in determining a consumer's ability to repay a covered transaction. Consistent with current § 226.34(a)(4), proposed § 226.43(c)(2)(vi) would not distinguish between pre-existing closed-end and open-end mortgage obligations. The Board believes consistency requires that it take the same approach when determining how to consider mortgage obligations that come into existence concurrently with a first-lien loan as is taken for pre-existing mortgage obligations, whether the first-lien is a purchase or non-purchase transaction (*i.e.,* refinancing). Including HELOCs in the proposed definition of "simultaneous loan" for purposes of TILA Section 129C(a)(2) is also generally consistent with current comment 34(a)(4)–3, and the 2006 Nontraditional Mortgage Guidance regarding simultaneous second-lien loans.[38]

Second, data indicate that where a subordinate loan is originated concurrently with a first-lien loan to provide some or all of the downpayment (*i.e.,* "piggyback loan"), the default rate on the first-lien loan increases significantly, and in direct correlation to increasing combined loan-to-value ratios.[39] The data does not distinguish between "piggyback loans" that are closed-end or open-end credit transactions, or between purchase and non-purchase transactions. However, empirical evidence demonstrates that approximately 60% of consumers who open a HELOC concurrently with a first-lien loan borrow against the line of credit at the time of origination,[40] suggesting that in many cases the HELOC may be used to provide some, or all, of the downpayment on the first-lien loan.

The Board recognizes that consumers have varied reasons for originating a HELOC concurrently with the first-lien loan, for example, to reduce overall closing costs or for the convenience of having access to an available credit line in the future. However, the Board believes concerns relating to HELOCs originated concurrently for savings or convenience, and not to provide payment towards the first-lien home purchase loan, may be mitigated by the Board's proposal to require that a creditor consider the periodic payment on the simultaneous loan based on the actual amount drawn from the credit line by the consumer. *See* proposed § 226.43(c)(6)(ii), discussing payment calculation requirements for simultaneous loans that are HELOCs. Still, the Board recognizes that in the case of a non-purchase transaction (*e.g.,*

[38] *See* 2006 Nontraditional Mortgage Guidance, 71 FR 58609, 58614 (Oct.4, 2006).

[39] Kristopher Gerardi, Andreas Lehnert, Shane Sherlund, and Paul S. Willen, "Making Sense of the Subprime Crisis," *Brookings Papers on Economic Activity* (Fall 2008), at 40, Table 3.

[40] The Board conducted independent analysis using data obtained from the FRBNY Consumer Credit Panel to determine the proportion of piggyback HELOCs taken out in the same month as the first-lien loan that have a draw at the time of origination. Data used is extracted from credit record data in years 2003 through 2010. *See* Donghoon Less and Wilbert van der Klaauw, "An Introduction to the FRBNY Consumer Credit Panel," Staff Rept. No. 479 (Nov. 2010), *at http://data.newyorkfed.org/research/staff_reports/sr479.pdf,* for further description of the database.

a refinancing) a simultaneous loan that is a HELOC is unlikely to be originated and drawn upon to provide payment towards the first-lien loan, except perhaps towards closing costs. The Board solicits comment on whether it should narrow the requirement to consider simultaneous loans that are HELOCs to apply only to purchase transactions. *See* discussion under proposed § 226.43(c)(6).

Third, in developing this proposal staff conducted outreach with a variety of participants that consistently expressed the view that second-lien loans significantly impact a consumer's performance on the first-lien loan, and that many second-lien loans are HELOCs. One industry participant explained that the vast majority of "piggyback loans" it originated were HELOCs that were fully drawn at the time of origination and used to assist in the first-lien purchase transaction. Another outreach participant stated that HELOCs make up approximately 90% of their simultaneous loan book-of-business. Industry outreach participants generally indicated that it is a currently an accepted underwriting practice to include HELOCs in the repayment ability assessment on the first-lien loan, and generally confirmed that the majority of simultaneous liens considered during the underwriting process are HELOCs. Thus, for these reasons, the Board proposes to use its authority under TILA Sections 105(a) and 129B(e) to broaden the scope of TILA Section 129C(a)(2), and accordingly proposes to define the term "simultaneous loan" to include HELOCs.

Proposed § 226.43(b)(12) defines a "simultaneous loan" to mean another covered transaction or home equity line of credit subject to § 226.5b that will be secured by the same dwelling and made to the same consumer at or before consummation of the covered transaction. The proposed definition generally tracks the meaning of "other dwelling-secured obligations" under current comment 34(a)(4)–3, as well as the statutory language of TILA Section 129C(a)(2) with the notable difference that the proposed term would include HELOCs, as discussed above. The Board proposes to replace the term "residential mortgage loan" with the term "covered transaction," as defined in proposed § 226.43(b)(1), for clarity. The Board also proposes to add a reference to the phrase "at or before consummation of the covered transaction" to further clarify that the definition does not include pre-existing mortgage obligations. Pre-existing mortgage obligations would be included as current debt obligations under proposed § 226.43(c)(2)(vi), which is discussed below. Last, the Board proposes to not include the statutory language that "the creditor shall make a reasonable and good faith determination, based on verified and documented information, that the consumer has a reasonable ability to repay the combined payments of all loans on the same dwelling according to the terms of those loans and all applicable taxes, insurance (including mortgage guarantee insurance), and assessments," because these statutory requirements are addressed in the repayment ability provisions in proposed § 226.43(c)(2)(iv) and (v), which are discussed more fully below.

Proposed comment 43(b)(12)–1 clarifies that the definition of "simultaneous loan" includes any loan that meets the definition, whether made by the same creditor or a third-party creditor, and provides an illustrative example of this principle. This proposed comment assumes a consumer will enter into a legal obligation that is a covered transaction with Creditor A. Immediately prior to consummation of the covered transaction with Creditor A, the consumer opens a HELOC that is secured by the same dwelling with Creditor B. This proposed comment explains that for purposes of this section, the loan extended by Creditor B is a simultaneous loan. To facilitate compliance, the comment would cross-reference to § 226.43(c)(2)(iv) and (c)(6) and associated commentary for further discussion of the requirement to consider the consumer's payment obligation on any simultaneous loan for purposes of determining the consumer's ability to repay the covered transaction subject to this section.

Proposed comment 43(b)(12)–2 further clarifies the meaning of the term "same consumer, and explains that for purposes of the definition of "simultaneous loan," the term "same consumer" includes any consumer, as that term is defined in § 226.2(a)(11), that enters into a loan that is a covered transaction and also enters into another loan (*e.g.,* second-lien covered transaction or HELOC) secured by the same dwelling. This comment further explains that where two or more consumers enter into a legal obligation that is a covered transaction, but only one of them enters into another loan secured by the same dwelling, the "same consumer" includes the person that has entered into both legal obligations. This proposed comment provides the following illustrative example: Assume Consumer A and Consumer B will both enter into a legal obligation that is a covered transaction with a creditor. Immediately prior to consummation of the covered transaction, Consumer B opens a HELOC that is secured by the same dwelling with the same creditor; Consumer A is not a signatory to the HELOC. For purposes of the definition of "simultaneous loan," Consumer B is the same consumer and the creditor must include the HELOC as a simultaneous loan. The Board believes this comment reflects statutory intent to include any loan that could impact the consumer's ability to repay the covered transaction according to its terms (*i.e.,* to require the creditor to consider the combined payment obligations of the consumer(s) obligated to repay the covered transaction). *See* TILA 129C(a)(2).

The term "simultaneous loan" appears in the following provisions: (1) Proposed § 226.43(c)(2)(iv), which implements the requirement under TILA § 129C(a)(2) that a creditor consider a consumer's monthly payment obligation on a simultaneous loan that the creditor "knows or has reason to know" will be made to the consumer; (2) proposed § 226.43(c)(6), which addresses the payment calculations for a simultaneous loan for purposes of proposed § 226.43(c)(2)(iv); and (3) proposed Alternative 2—§ 226.43(e)(2)(v)(C), which requires the creditor to consider a simultaneous loan as a condition to meeting the definition of a qualified mortgage.

43(b)(13) Third-Party Record

TILA Section 129C(a)(1) requires that creditors determine a consumer's repayment ability using "verified and documented information,"and TILA Section 129C(a)(4) specifically requires verifying a consumer's income or assets relied on to determine repayment ability using a consumer's tax return or "third-party documents" that provide reasonably reliable evidence of the consumer's income or assets, as discussed in detail below in the section-by-section analysis of proposed § 226.43(c)(3) and (4). The Board believes that in general creditors should rely on reasonably reliable records prepared by a third party to verify repayment ability under TILA Section 129C(a), consistent with verification requirements under the Board's 2008 HOEPA Final Rule. *See* § 226.34(a)(4)(ii). However, the Board believes that in some cases a record prepared by the creditor for a covered transaction can provide reasonably reliable evidence of a consumer's repayment ability, such as a creditor's records regarding a consumer's savings account held by the creditor or employment records for a consumer employed by the creditor. Further, TILA Section 129C(a)(4) allows creditors to use a consumer-prepared tax return to verify the consumer's income or assets. Proposed § 226.43(b)(13) therefore would define the term "third-party records" to include certain records prepared by the consumer or creditor, for consistency and simplicity in implementing verification requirements under TILA Sections 129C(a)(1) and (4).

Proposed § 226.43(b)(13) provides that "third-party record" means: (1) A document or other record prepared or reviewed by a person other than the consumer, the creditor, any mortgage broker, as defined in § 226.36(a)(2), or any agent of the creditor or mortgage broker; (2) a copy of a tax return filed with the Internal Revenue Service or a state taxing authority; (3) a record the creditor maintains for an account of the consumer held by the creditor; or (4) if the consumer is an employee of the creditor or the mortgage broker, a document or other record regarding the consumer's employment status or income. *See* proposed § 226.43(b)(13)(i)–(iv).

Proposed comment 43(b)(13)–1 clarifies that third party records include records transmitted or viewed electronically, for example, a credit report prepared by a consumer reporting agency and transmitted or viewed electronically. Proposed comment 43(b)(13)–2 explains that a third-party record includes a form a creditor provides to a third party for providing information, even if the creditor completes parts of the form unrelated to the information sought. Proposed comment 43(b)(13)–2 provides an example where the creditor gives the consumer's employer a form for verifying the consumer's employment status and income and clarifies that the creditor may fill in the creditor's name and other portions of the form unrelated to the consumer's employment status or income. Proposed comment 43(b)(13)(i)–1 clarifies that a third-party record includes a document or other record prepared by the consumer, the creditor, the mortgage broker, or an agent of the creditor or mortgage broker, if the record is reviewed by a third party. For example, a profit-and-loss statement prepared by a self-employed consumer and reviewed by a third-party accountant is a third-party record under § 226.43(b)(13)(i). Finally, proposed comment 43(b)(13)(iii)–1 clarifies that a third-party record includes a record the creditor maintains for an account of the consumer held by the creditor, and provides the examples of checking accounts, savings accounts, and retirement accounts. Proposed comment 43(b)(13)(iii)–1 also provides the example of a creditor's records for an account related to a consumer's outstanding obligations to the creditor, such as the creditor's records for a first-lien mortgage to a consumer who applies for a subordinate-lien home equity loan.

43(c) Repayment Ability

TILA Section 129C(a)(1) provides that no creditor may make a residential mortgage loan unless the creditor makes a reasonable and good faith determination that, at the time the loan is consummated, the consumer has a reasonable ability to repay the loan according to its terms and all applicable taxes, insurance, and assessments. TILA Section 129C(a)(2) provides that if a creditor knows or has reason to know that one or more residential mortgage loans secured by the dwelling that secures the covered transaction will be made to the same consumer, the creditor must make a reasonable and good faith determination that the consumer has a reasonable ability to repay the other loan(s) and all taxes, insurance, and assessments applicable to the other loan(s). TILA Section 129C(a)(3) provides that to determine the consumer's repayment ability creditors must consider: The consumer's (1) credit history; (2) current income and reasonably expected income; (3) current obligations; (4) debt-to-income ratio or the residual income the consumer will have after paying non-mortgage debt and mortgage-related obligations; (5) employment status; and (6) financial resources other than the consumer's equity in the dwelling that secures repayment of the loan. Further, creditors must base their determination of the consumer's repayment ability on verified and documented information. Finally, TILA Section 129C(a)(3) provides that creditors must use a payment schedule that fully amortizes the loan over the loan term in determining the consumer's repayment ability. These TILA provisions are substantially similar to the repayment ability requirements under the Board's 2008 HOEPA Final Rule. *See* § 226.34(a)(4), 226.35(b)(1).

Proposed § 226.43(c) would implement TILA Section 129C(a)(1)–(3) and is substantially similar to those provisions. Specifically, proposed § 226.43(c) provides that a creditor:

- Must not make a covered transaction unless the creditor makes a reasonable and good faith determination at or before consummation that the consumer will have a reasonable ability, at the time of consummation, to repay the loan according to its terms, including any mortgage-related obligations;
- Must make the repayment ability determination by considering the consumer's:
  - Current or reasonably expected income or assets other than the value of the dwelling, or of any real property to which the dwelling is attached, that secures the loan;
  - Employment status, if the creditor relies on income from the consumer's employment in determining repayment ability;
  - Monthly payment on the covered transaction;
  - Monthly payment on any simultaneous loan that the creditor knows or has reason to know will be made;
  - Monthly payment for mortgage-related obligations;
  - Current debt obligations;
  - Monthly debt-to-income ratio or residual income; and
  - Credit history; and
- Must verify a consumer's repayment ability using reasonably reliable third-party records.

Proposed comment 43(c)–1 clarifies that, to evaluate a consumer's repayment ability, creditors may look to widely accepted governmental or non-governmental underwriting standards, such as the Federal Housing Administration's Handbook on Mortgage Credit Analysis for Mortgage Insurance on One-to-Four Unit Mortgage Loans. Proposed comment 43(c)–1 states, for example, that creditors may use such standards in determining: (1) Whether to classify particular inflows, obligations, or property as "income," "debt," or "assets"; (2) factors to consider in evaluating the income of a self-employed or seasonally-employed consumer; and (3) factors to consider in evaluating the credit history of a consumer who has obtained few or no extensions of traditional "credit," as defined in § 226.2(a)(14). Proposed comment 43(c)–1 is consistent with, but broader than, current commentary on determining a consumer's debt-to-income ratio to meet the presumption of compliance with the repayment ability requirement of the Board's 2008 HOEPA Final Rule. *See* § 226.34(a)(4)(iii)(C), 226.35(b)(1). Currently, comment 34(a)(4)(iii)(C)–1 states that creditors may look to widely accepted underwriting standards to determine whether to classify particular inflows or obligations as "income" or "debt."

The Board's proposed rule provides flexibility in underwriting standards so that creditors may adapt their underwriting processes to a consumer's particular circumstances, such as to the needs of self-employed consumers and consumers heavily dependent on bonuses and commissions, consistent with the Board's 2008 HOEPA Final Rule. *See* 73 FR 44522, 44547, July 30, 2008. For example, the proposed rule does not prescribe: How many years of tax returns or other information a creditor must consider to determine the consumer's repayment ability; which income figure on tax returns creditors must use; the elements of credit history to be considered, such as late payments or bankruptcies; the way in which to verify credit history, such as by using a tri-merge report or records of rental payments; or a specific maximum debt-to-income ratio or the compensating factors to allow a consumer to exceed such a ratio. The Board believes such flexibility is necessary because the rule would cover such a wide variety of consumers and mortgage products.

Removal of § 226.34(a)(4) and 226.35(b)(1). Repayment ability requirements under TILA Section 129C(a) apply to all dwelling-secured consumer credit transactions, other than HELOCs, reverse mortgages, temporary or "bridge" loans with a loan term of 12 months or less, and timeshare transactions, as discussed in detail above in the section-by-section analysis of proposed § 226.43(a). Accordingly, the Board proposes to implement TILA Section 129C in a new § 226.43 and remove requirements to consider repayment ability for high-cost mortgages under § 226.34(a)(4) and for higher-priced mortgage loans under § 226.35(b)(1), as discussed in detail above in the section-by-section analysis of § 226.34 and 226.35.

43(c)(1) General Requirement

Proposed § 226.43(c)(1) would implement TILA Section 129C(a)(1) and provides that no creditor may make a covered transaction unless the creditor makes a reasonable and good faith determination at or before consummation that the consumer will have a reasonable ability, at the time of consummation, to repay the covered transaction according to its terms, including any mortgage-related obligations. Proposed comment 43(c)(1)–1 clarifies that a change in the consumer's circumstances after consummation (for example, a significant reduction in income due to a job loss or a significant obligation arising from a major medical expense) that is not reflected in the consumer's application or the records used to determine repayment ability is not relevant to determining a creditor's compliance with the rule. However, proposed comment 43(c)(1)–1 states further that if such application or records state there will be a change in the consumer's repayment ability after consummation (for example, if a consumer's application states that the consumer plans to retire within twelve months without obtaining new employment or transition from full-time to part-time employment), the creditor must consider that information. Proposed comment 43(c)(1)–1 is substantially similar to current comment 34(a)(4)–5 adopted by the Board's 2008 HOEPA Final Rule.

Proposed comment 43(c)(1)–2 clarifies that proposed § 226.43(c)(1) does not require or permit the creditor to make inquiries prohibited by Regulation B, 12 CFR part 202, consistent with current comment 34(a)(4)–7 adopted by the Board's 2008 HOEPA Final Rule.

43(c)(2) Basis for Determination

TILA Section 129C(a)(3) provides that to determine a consumer's repayment ability, creditors must consider a consumer's credit history, current and reasonably expected income, current obligations, debt-to-income ratio or the residual income the consumer will have after paying non-mortgage debt and mortgage-related obligations, employment status, and "financial resources" other than the consumer's equity in the dwelling or real property that secures repayment of the loan. TILA Section 129C(a)(3) also provides that creditors must determine repayment ability using a repayment schedule that fully amortizes the loan over the loan term. Proposed § 226.43(c)(2) would implement the requirement to consider specific factors in determining repayment ability. Proposed § 226.43(c)(2) is substantially similar to TILA Section 129C(a)(3), except for some minor terminology changes, as discussed below.

43(c)(2)(i) Income or Assets

TILA Section 129C(a)(3) provides that in making the repayment ability determination, creditors must consider, among other factors, a consumer's current income, reasonably expected income, and "financial resources" other than the consumer's equity in the dwelling or real property that secures loan repayment. Furthermore, under TILA Section 129C(a)(9), creditors may consider the seasonality or irregularity of a consumer's income in determining repayment ability.

Proposed § 226.43(c)(2)(i) generally mirrors TILA Section 129C(a)(3) but differs in two respects. First, proposed § 226.43(c)(2)(i) uses the term "assets" rather than "financial resources," to conform with terminology used in other provisions under TILA Section 129C(a) and Regulation Z. *See, e.g.* TILA Section 129C(a)(4) (requiring that creditors consider a consumer's assets in determining repayment ability); § 226.51(a) (requiring consideration of a consumer's assets in determining a consumer's ability to repay a credit extension under a credit card account). The Board believes the terms "financial resources" and "assets" are synonymous as used in TILA Section 129C(a), and the term "assets" is used throughout the proposal for consistency.

Second, proposed § 226.43(c)(2)(i) provides that creditors may not look to the value of the dwelling that secures the covered transaction, instead of providing that creditors may not look to the consumer's equity in the dwelling. The Board believes that TILA Section 129C(a)(3) is intended to address the risk that creditors will consider the amount that could be obtained through a foreclosure sale of the dwelling, which may exceed the amount of the consumer's equity in the dwelling. This approach is consistent with the Board's 2008 HOEPA Final Rule, which prohibits a creditor from extending credit "based on the value of the consumer's collateral." *See* § 226.34(a)(4), 226.35(b)(1). The Board proposes this adjustment pursuant to its authority under TILA Section 105(a), which provides that the Board's regulations may contain such additional requirements, classifications, differentiations, or other provisions, and may provide for such adjustments and exceptions for all or any class of transactions as in the Board's judgment are necessary or proper to effectuate the purposes of TILA, prevent circumvention or evasion thereof, or facilitate compliance therewith. 15 U.S.C. 1604(a). This approach is further supported by the Board's authority under TILA Section 129B(e) to condition terms, acts or practices relating to residential mortgage loans that the Board finds necessary or proper to effectuate the purposes of TILA. 15 U.S.C. 1639b(e). One of the purposes of TILA is to "assure that consumers are offered and receive residential mortgage loan on terms that reasonably reflect their ability to repay the loans." TILA Section 129B(a)(2); 15 U.S.C. 1629b(a)(2). The Board believes providing that creditors may not consider the value of the dwelling is proper to effectuate the purposes of TILA Section 129C(a) that creditors extend credit based on the consumer's repayment ability rather than on the dwelling's foreclosure value. *See* TILA Section 129B(a)(2).

Proposed comment 43(c)(2)(i)–1 clarifies that creditors may base a determination of repayment ability on current or reasonably expected income from employment or other sources, assets other than the dwelling that secures the covered transaction, or both. Proposed comment 43(c)(2)(i)–2 cross-references proposed comment 43(a)–2 to clarify that the value of the dwelling includes the value of the real property to which the dwelling is attached, if the real property also secures the covered transaction. Proposed comment 43(c)(2)(i)–1 also 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; and examples of assets the creditor may consider, including funds in a savings or checking account, amounts vested in a retirement account, stocks, and bonds. The proposed comment is substantially similar to comment 34(a)(4)–6 adopted by the Board's 2008 HOEPA Final Rule, but adds additional examples of income and assets to facilitate compliance. Proposed comment 43(c)(2)(i)–2 clarifies that if a creditor bases its determination of repayment ability entirely or in part on a consumer's income, the creditor need consider only the income necessary to support a determination that the consumer can repay the covered transaction. For example, if a consumer earns income from a full-time job and a part-time job and the creditor reasonably determines that the consumer's income from a full-time job is sufficient to repay the covered transaction, the creditor need not consider the consumer's income from the part-time job. Further, the creditor need verify only the income (and assets) relied on to determine the consumer's repayment ability, as discussed below in the section-by-section analysis of proposed § 226.43(c)(4). Proposed comment 43(c)(2)(i)–2 cross-references proposed comment 43(c)(4)–1, which is substantially similar to current comment 34(a)(4)(ii)–1, adopted by the Board's 2008 HOEPA Final Rule.

Expected income. TILA Section 129C(a) provides that creditors must consider a consumer's current and reasonably expected income to determine repayment ability. This is consistent with current § 226.34(a)(4), but commentary on § 226.34(a)(4) clarifies that creditors need consider a consumer's reasonably expected income only if the creditor relies on such income in determining repayment ability. *See* comments 34(a)(4)(ii)–1, –3. The Board believes that the requirement to consider a consumer's reasonably expected income under TILA Section 129C(a) should be interpreted consistent with current § 226.34(a)(4), in light of the substantial similarity between the provisions. Accordingly, proposed § 226.43(c)(2)(i) provides that creditors must consider a consumer's current income or reasonably expected income. Proposed comment 43(c)(2)(i)–3 clarifies that the creditor may rely on the consumer's reasonably expected income either in addition to or instead of current income.

Proposed comment 43(c)(2)(i)–3 further clarifies that if creditors rely on expected income, the expectation that the income will be available for repayment must be reasonable and verified with third-party records that provide reasonably reliable evidence of the consumer's expected income. Proposed comment 43(c)(2)(i)–3 also gives examples of expected bonuses verified with documents demonstrating past bonuses, and expected salary from a job verified with a written statement from an employer stating a specified salary, consistent with current comment 34(a)(4)(ii)–3 adopted by the Board's 2008 HOEPA Final Rule. As the Board stated in connection with the 2008 HOEPA Final Rule, in some cases a covered transaction may have a likely payment increase that would not be affordable at the borrower's income at the time of consummation. A creditor may be able to verify a reasonable expectation of an increase in the borrower's income that will make the higher payment affordable to the borrower. *See* 73 FR 44522, 44544, July 30, 2008.

Seasonal or irregular income. TILA Section 129C(a)(9) provides that creditors may consider the seasonality or irregularity of a consumer's income in determining repayment ability. Accordingly, proposed comment 43(c)(2)(i)–4 clarifies that a creditor reasonably may determine that a consumer can make periodic loan payments even if the consumer's income, such as self-employment income, is seasonal or irregular. Proposed comment 43(c)(2)(i)–4 states, for example, that if the creditor determines that the income a consumer receives a few months each year from selling crops is sufficient to make monthly loan payments when divided equally across 12 months, the creditor reasonably may determine that the consumer can repay the loan, even though the consumer may not receive income during certain months. Comment 43(c)(2)(i)–4 is consistent with current comment 34(a)(4)–6 adopted by the Board's 2008 HOEPA Final Rule but provides an example of seasonal or irregular income that is not employment income.

43(c)(2)(ii) Employment Status

TILA Section 129C(a)(3) requires that creditors consider a consumer's employment status in determining the consumer's repayment ability, among other requirements. Proposed § 226.43(c)(2)(ii) implements this requirement and clarifies that creditors need consider a consumer's employment status only if they rely on income from the consumer's employment in determining repayment ability. Proposed comment 43(c)(2)(ii)–1 states, for example, that if a creditor relies wholly on a consumer's investment income to determine the consumer's repayment ability, the creditor need not verify the consumer's employment status. Proposed comment 43(c)(2)(ii)–1 clarifies that employment may be full-time, part-time, seasonal, irregular, military, or self-employment. This comment is consistent with current comment 34(a)(4)–6 adopted by the Board's 2008 HOEPA Final Rule.

Employment status of military personnel. Creditors in general must verify information relied on to determine repayment ability using reasonably reliable third-party records but may verify employment status orally as long as they prepare a record of the oral information, as discussed below in the section-by-section analysis of proposed § 226.43(c)(3)(ii). Proposed comment 43(c)(2)(ii)–2 clarifies that creditors also may verify the employment status of military personnel using the electronic database maintained by the Department of Defense (DoD) to facilitate identification of consumers covered by credit protections provided pursuant to 10 U.S.C. 987, also known as the "Talent Amendment."[41] The Board solicits comment on whether additional flexibility in verifying the employment status of military personnel is necessary to facilitate compliance and whether comment 43(c)(2)(ii)–2 also should state that creditors may verify the employment status of a member of the military using a Leave and Earnings Statement. Is a Leave and Earnings Statement as reliable a means of

[41] The Talent Amendment is contained in the John Warner National Defense Authorization Act. *See* Public Law 109–364, 120 Stat. 2083, 2266, Oct. 17, 2006; *see also* 72 FR 50580, 5088, Aug. 31, 2007 (discussing the DoD database in a final rule implementing the Talent Amendment). Currently, the DoD database is available at *https://www.dmdc.osd.mil/appj/mla/.*

verifying the employment status of military personnel as using the electronic database maintained by the DoD? Is a Leave and Earnings Statement equally reliable for determining employment status for a civilian employee of the military as for a service member?

The Board solicits comment on this approach, and on whether there are other specific employment situations for which additional guidance should be provided.

43(c)(2)(iii) Monthly Payment on the Covered Transaction

Proposed § 226.43(c)(2)(iii) would implement the requirements under TILA Section 129C(a)(1) and (3), in part, by requiring that the creditor consider the consumer's monthly payment on the covered transaction, calculated in accordance with proposed § 226.43(c)(5) for purposes of determining the consumer's repayment ability on a covered transaction. *See* proposed § 226.43(c)(5) for a discussion of the proposed payment calculation requirements. Proposed comment 43(c)(2)(iii)–1 would clarify that for purposes of the repayment ability determination, the creditor must consider the consumer's monthly payment on a covered transaction that is calculated as required under proposed § 226.43(c)(5), taking into account any mortgage-related obligations. This comment would also provide a cross-reference to proposed § 226.43(b)(8) for the meaning of the term "mortgage-related obligations."

43(c)(2)(iv) Simultaneous Loans

Proposed § 226.43(c)(2)(iv) requires that the creditor consider the consumer's monthly payment obligation on any simultaneous loan that the creditor knows or has reason to know will be made to the consumer. Proposed § 226.43(c)(2)(iv) also requires that the consumer's monthly payment obligation on the simultaneous loan be calculated in accordance with proposed § 226.43(c)(6), which is discussed below. Proposed § 226.43(c)(2)(iv) implements TILA Section 129C(a)(2), which provides that "if a creditor knows, or has reason to know, that 1 or more residential mortgage loans secured by the same dwelling will be made to the same consumer, the creditor shall make a reasonable and good faith determination, based on verified and documented information, that the consumer has a reasonable ability to repay the combined payments of all loans on the same dwelling according to the terms of those loans and all applicable taxes, insurance (including mortgage guarantee insurance), and assessments." As discussed under proposed § 226.43(b)(12), the Board is proposing to use its authority under TILA Sections 105(a) and 129B(e) to broaden the scope of TILA Section 129C(a)(2) to include HELOCs, and define the term "simultaneous loan" accordingly, for purposes of the requirements under proposed § 226.43(c)(2)(iv) and (c)(6). 15 U.S.C. 1604(a).

Proposed comment 43(c)(2)(iv)–1 clarifies that for purposes of the repayment ability determination, 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. This comment explains that a HELOC that is a simultaneous loan that the creditor knows or has reason to know about must be considered as a mortgage obligation in determining a consumer's ability to repay the covered transaction, even though the HELOC is not a covered transaction subject to § 226.43. To facilitate compliance, this comment cross-references proposed § 226.43(a), which discusses the scope of the ability-to-repay provisions, proposed § 226.43(b)(12) for the meaning of the term "simultaneous loan," and proposed comment 43(b)(12)–2 for further explanation of the term "same consumer."

Proposed comment 43(c)(2)(iv)–2 provides additional guidance regarding the standard "knows or has reason to know" for purposes of proposed § 226.43(c)(2)(iv) and explains that, for example, where a covered transaction is a home purchase loan, the creditor must consider the consumer's periodic payment obligation for any "piggyback" second-lien loan that the creditor knows or has reason to know will be used to finance part of the consumer's down payment. This comment would provide that the creditor complies with this requirement where, for example, the creditor follows policies and procedures that show at or before consummation that the same consumer has applied for another credit transaction secured by the same dwelling.

This proposed comment would provide the following illustrative example: Assume a creditor receives an application for a home purchase loan where the requested loan amount is less than the home purchase price. The creditor's policies and procedures require the consumer to state the source of the downpayment. If the creditor determines the source of the downpayment is another extension of credit that will be made to the same consumer at consummation and secured by the same dwelling, the creditor knows or has reason to know of the simultaneous loan and must consider the simultaneous loan. Alternatively, if the creditor has information that suggests the downpayment source is the consumer's income or existing assets, the creditor would be under no further obligation to determine whether a simultaneous loan will be extended at or before consummation of the covered transaction.

Proposed comment 43(c)(2)(iv)–3 clarifies the scope of timing and the meaning of the phrase "at or before consummation" with respect to simultaneous loans that the creditor must consider for purposes of proposed § 226.43(c)(2)(iv). This comment would explain that a simultaneous loan includes a loan that comes into existence concurrently with the covered transaction subject to proposed § 226.43(c). The comment would further state that, in all cases, a simultaneous loan does not include a credit transaction that occurs after consummation of the covered transaction subject to proposed § 226.43(c).

Proposed comment 43(c)(2)(iv)–4 provides further guidance regarding verification of simultaneous loans. This comment would state that although a credit report may be used to verify current obligations, it will not reflect a simultaneous loan that has not yet been consummated or has just recently been consummated. This comment would explain that if the creditor knows or has reason to know that there will be a simultaneous loan extended at or before consummation, the creditor may verify the simultaneous loan by obtaining third-party verification from the third-party creditor of the simultaneous loan. The comment would provide, as an example, that the creditor may obtain a copy of the promissory note or other written verification from the third-party creditor in accordance with widely accepted governmental or non-governmental standards. To facilitate compliance, the comment would cross-reference proposed comments 43(c)(3)–1 and –2, which discuss verification using third-party records. Based on outreach, the Board believes it is feasible for creditors to obtain copies of promissory notes or other written verification from third-party creditors, but solicits comment on other examples the Board could provide to facilitate creditors' compliance with the proposed verification requirement with respect to simultaneous loans.

The Board notes that proposed § 226.43(c)(2)(iv) requires creditors to consider a simultaneous loan when assessing the consumer's ability to repay a covered transaction, regardless of whether the simultaneous loan is made in connection with a purchase or non-purchase covered transaction (*i.e.,* refinancing). As discussed more fully below under proposed § 226.43(c)(6), which addresses payment calculation requirements for simultaneous loans, the Board recognizes that in the case of a non-purchase transaction, a simultaneous loan that is a HELOC is unlikely to be originated and drawn upon to provide payment towards the first-lien loan being refinanced, except perhaps towards closing costs. The Board is soliciting comment on whether it should narrow the requirement to consider simultaneous loans that are HELOCs to apply only to purchase transactions. *See* discussion under proposed § 226.43(c)(6) regarding payment calculations for simultaneous loans.

43(c)(2)(v) Mortgage-Related Obligations

Proposed § 226.43(c)(2)(v) implements the requirement under TILA Sections 129C(a)(1)–(3) that the creditor determine a consumer's repayment ability taking into account the consumer's monthly payment for any mortgage-related obligations, based on verified and documented information as required under proposed § 226.43(c)(3). TILA Sections 129C(a)(1) and (2) require that the creditor determine a consumer's repayment ability on a covered transaction based on verified and documented information, "according to [the loans's] terms, and all applicable taxes, insurance (including mortgage guarantee insurance), and assessments." TILA Section 129C(a)(3) further requires that a consumer's debt-to-income ratio be considered as part of the repayment ability determination after allowing for "non-mortgage debt and mortgage-related obligations." The Dodd-Frank Act does not define the term "mortgage-related obligations." As discussed in proposed § 226.43(b)(8), the Board proposes to use the term "mortgage-related obligations" to refer to "all applicable taxes, insurance (including mortgage guarantee insurance), and assessments." Proposed § 226.43(b)(8) would define the term "mortgage-related obligations" to mean property taxes; mortgage-related insurance premiums required by the creditor as set forth in proposed § 226.45(b)(1);[42] homeowner association, condominium, and cooperative fees; ground rent or leasehold payments; and special assessments.

Proposed § 226.43(c)(2)(v) is generally consistent with the requirement under current § 226.34(a)(4) of the Board's 2008 HOEPA Final Rule that the creditor include mortgage-related obligations when determining the consumer's repayment ability on the loan, except that § 226.34(a)(4) does not extend the verification requirement to mortgage-related obligations. In contrast, under proposed § 226.43(c)(3) creditors would need to verify mortgage-related obligations for purposes of the repayment ability determination. *See* proposed § 226.43(c)(3) and associated commentary discussing the verification requirement generally.

Proposed comment 43(c)(2)(v)–1 states that the creditor must include in its repayment ability assessment the consumer's mortgage-related obligations, such as the expected property taxes and premiums for mortgage-related insurance required by the creditor as set forth in proposed § 226.45(b)(1). This comment would clarify, however, that creditors need not include mortgage-related insurance premiums that the creditor does not require, such as credit insurance or fees for optional debt suspension and debt cancellation agreements. This comment would also explain that mortgage-related obligations must be included in the creditor's determination of repayment ability regardless of whether the amounts are included in the monthly payment or whether there is an escrow account established. To facilitate compliance, this comment would cross-reference proposed § 226.43(b)(8) for the meaning of the term "mortgage-related obligations."

As discussed more fully below under proposed § 226.43(c)(5), the Dodd-Frank Act provisions require creditors to determine the consumer's ability to repay based on monthly payments, taking into account mortgage-related obligations. However, the Board recognizes that creditors will need to convert mortgage-related obligations that are not monthly to *pro rata* monthly amounts to comply with this proposed requirement. Thus, proposed comment 43(c)(2)(v)–2 clarifies that, in considering mortgage-related obligations that are not paid monthly, the creditor may look to widely accepted governmental or non-governmental standards in determining the *pro rata* monthly payment amount. The Board solicits comment on operational difficulties creditors may encounter when complying with this "monthly" requirement, and whether additional guidance is necessary.

Proposed comment 43(c)(2)(v)–3 explains that estimates of mortgage-related obligations should be based upon information that is known to the creditor at the time the creditor underwrites the mortgage obligation. This comment would further explain that information is known if it is "reasonably available" to the creditor at the time of underwriting the loan, and would cross-reference current comment 17(c)(2)(i)–1 for the meaning of "reasonably available." The Board believes it is appropriate to permit creditors to use estimates of mortgage-related obligations because actual amounts may be unknown at the time of underwriting. For example, outreach participants confirmed that the current underwriting practice is to use estimates of property taxes because actual property tax amounts are typically unknown until consummation. Proposed comment 43(c)(2)(v)–3 further clarifies that for purposes of proposed § 226.43(c), the creditor would not need to project potential changes, such as by estimating possible increases in taxes and insurance.

Proposed comment 43(c)(2)(v)–4 states that creditors must make the repayment ability determination required under proposed § 226.43(c) based on information verified from reasonably reliable records. This comment would explain that guidance regarding verification of mortgage-related obligations can be found in proposed comments 43(c)(3)–1 and –2, which discuss verification using third-party records. The Board solicits comment on any special concerns regarding the requirement to document certain mortgage-related obligations, such as for ground rent or leasehold payments, or special assessments. The Board also solicits comment on whether it should provide, by way of example, that the HUD–1 or 1A, or a successor form, can serve as verification of certain mortgage-related obligations reflected therein (*e.g.,* title insurance), where a legal obligation exists to complete the HUD–1 or 1A accurately. *See* 24 CFR 3500.1 *et seq.* of Regulation X, which implements the Real Estate Settlement Procedures Act (RESPA), 15 U.S.C. 2601 *et seq.*

43(c)(2)(vi) Current Debt Obligations

TILA Section 129C(a)(1) and (3) requires creditors to consider and verify "current obligations" as part of the repayment ability determination. This new TILA provision is consistent with the 2008 HOEPA Final Rule, which prohibits creditors from extending

[42] *See* 2011 Escrow Proposal, 76 FR 11598, 11621, Mar. 2, 2011.

credit without regard to a consumer's repayment ability, including a consumer's current obligations, and requires creditors to verify the consumer's current obligations. Sections 226.34(a)(4) and (a)(4)(ii)(C), 226.35(b)(1). In addition, current comment 34(a)(4)(iii)(C)–1 provides that creditors may look to widely accepted governmental and non-governmental underwriting standards in defining "debt," including, for example, those set forth in the Federal Housing Administration's (FHA) handbook on Mortgage Credit Analysis for Mortgage Insurance on One- to Four-Unit Mortgage Loans. Finally, current comment 34(a)(4)(ii)(C)–1 provides that a credit report may be used to verify current obligations. If, however, a credit report does not reflect an obligation that a consumer has listed on an application, then the creditor is responsible for considering the obligation, but is not required to verify the existence or amount of the obligation through another source. If a creditor nevertheless verifies an obligation, the creditor must consider the obligation based on the information from the verified source.

Proposed § 226.43(c)(2)(vi) implements TILA Section 129C(a)(1) and (3) and requires creditors to consider the consumer's current debt obligations as part of the repayment ability determination. As discussed below, proposed § 226.43(c)(3) implements TILA Section 129C(a)(1) by requiring that a creditor verify a consumer's repayment ability, which would include the consumer's current debt obligations.

Proposed comment 43(c)(2)(vi)–1 clarifies that creditors may look to widely accepted governmental and non-governmental underwriting standards in determining how to define "current debt obligations" and how to verify such obligations. For example, a creditor would be required to consider student loans, automobile loans, revolving debt, alimony, child support, and existing mortgages. To verify current debt obligations as required by § 226.43(c)(3), a creditor would be permitted, for instance, look to credit reports, student loan statements, automobile loan statements, credit card statements, alimony or child support court orders, and existing mortgage statements. This approach would parallel the 2008 HOEPA Final Rule's model for consideration and verification of income and would preserve flexibility for creditors. The Board solicits comment on this approach, and on whether more specific guidance should be provided.

Proposed comment 43(c)(2)(vi)–2 states that if a credit report reflects a current debt obligation that a consumer has not listed on the application, the creditor must consider the obligation. The credit report is deemed a reasonably reliable third-party record under § 226.43(b)(3). Consistent with commentary to the 2008 HOEPA Final Rule, the proposed comment further provides that if a credit report does not reflect a current debt obligation that a consumer has listed on the application, the creditor must consider the obligation. However, the creditor need not verify the existence or amount of the obligation through another source, as discussed in the section-by-section analysis for § 226.43(c)(3) below. If a creditor nevertheless verifies an obligation, the creditor must consider the obligation based on the information from the verified source. The Board solicits comment on the feasibility of requiring creditors independently to verify current debt obligations not reflected in the credit report that a consumer has listed on the application. Such a requirement would be consistent with TILA Section 129C(a)(1), which requires the repayment ability determination to be based on verified information. On the other hand, requiring creditors to verify these obligations may result in increased compliance and litigation costs without offsetting benefits.

The Board solicits comment on three additional issues. First, the Board solicits comment on whether it should provide additional guidance on considering debt obligations that are almost paid off. For example, some underwriting standards limit the consideration of current debt obligations to recurring obligations extending 10 months or more, and recurring obligations extending less than 12 months if they affect the consumer's repayment ability in the months immediately after consummation. Requiring creditors to consider debts that are almost paid off would advance safe and responsible lending, but may unduly limit access to credit.

Second, the Board solicits comment on whether it should provide additional guidance on considering debt obligations that are in forbearance or deferral. For example, some underwriting standards do not include consideration of projected obligations deferred for at least 12 months, in particular student loans. Many creditors, however, consider all projected obligations. Permitting creditors not to consider debt obligations that are in forbearance or deferral may further limit access to credit, but may also run counter to safe and responsible lending.

Finally, the Board solicits comment on whether it should provide guidance on consideration and verification of current debt obligations for joint applicants. The Board also solicits comment on whether the guidance should differ for non-occupant joint applicants and occupant joint applicants.

43(c)(2)(vii) Debt-to-Income Ratio or Residual Income

TILA Section 129C(a)(3) requires creditors, as part of the repayment ability determination, to consider the debt-to-income ratio or the residual income the consumer will have after paying mortgage-related obligations and current debt obligations. This new TILA provision is consistent with the Board's 2008 HOEPA Final Rule, in which a creditor is presumed to have complied with the repayment ability requirement if, among other things, the creditor "assesses the consumer's repayment ability taking into account at least one of the following: The ratio of total debt obligations to income, or the income the consumer will have after paying debt obligations." Section 226.34(a)(4)(iii)(C), 226.35(b)(1). In addition, comment 34(a)(4)(iii)(C)–1 provides that creditors may look to widely accepted governmental and non-governmental underwriting standards in defining "income" and "debt," including, for example, those set forth in the Federal Housing Administration's (FHA) handbook on Mortgage Credit Analysis for Mortgage Insurance on One- to Four-Unit Mortgage Loans.

Proposed § 226.43(c)(2)(vii) implements TILA Section 129C(a)(3) and requires creditors, as part of the repayment ability determination, to consider the consumer's monthly debt-to-income ratio, or residual income. Proposed comment 43(c)(2)(vii)–1 cross-references § 226.43(c)(7) regarding the definitions and calculations for the monthly debt-to-income ratio and residual income.

Consistent with the 2008 HOEPA Final Rule, TILA Section 129C(a)(3) requires creditors to consider either the consumer's debt-to-income ratio or the consumer's residual income. As in the 2008 HOEPA Final Rule, the proposal provides creditors flexibility to determine whether using a debt-to-income ratio or residual income increases a creditor's ability to predict repayment ability. If one of these metrics alone holds as much predictive power as the two together, as may be true of certain underwriting models at certain times, then requiring creditors to use both metrics could reduce access to credit without an offsetting increase in consumer protection. 73 FR 44550, July 30, 2008. Outreach conducted by Board staff also indicates that residual income appears not to be as widely used or tested as the debt-to-income ratio.

43(c)(2)(viii) Credit History

TILA Section 129C(a)(1) and (3) requires creditors to consider and verify credit history as part of the ability-to-repay determination. Creditors must accordingly assess willingness to repay and not simply ability to repay. By contrast, the 2008 HOEPA Final Rule does not require consideration of credit history.

Proposed § 226.43(c)(2)(vii) implements TILA Section 129C(a)(3) and requires creditors to consider the consumer's credit history as part of the repayment ability determination. As discussed below, proposed § 226.43(c)(3) implements TILA Section 129C(a)(1) by requiring that a creditor verify a consumer's repayment ability, which would include the consumer's credit history.

Proposed comment 43(c)(2)(viii)–1 clarifies that creditors may look to widely accepted governmental and non-governmental underwriting standards to define and verify "credit history." For example, a creditor may consider factors such as the number and age of credit lines, payment history, and any judgments, collections, or bankruptcies. To verify credit history as required by § 226.43(c)(3), a creditor may, for instance, look to credit reports from credit bureaus, or other nontraditional credit references contained in third-party documents, such as rental payment history or public utility payments. The Board solicits comment on this approach.

43(c)(3) Verification Using Third-Party Records

TILA Section 129C(a)(1) requires that creditors make a reasonable and good faith determination, based on "verified and documented information," that a consumer has a reasonable ability to repay the covered transaction. The Board's 2008 HOEPA Final Rule requires that creditors verify the consumer's income or assets relied on to determine repayment ability and the consumer's current obligations. *See* § 226.34(a)(4)(ii)(A), (C). Thus, TILA Section 129C(a)(1) differs from the Board's 2008 HOEPA Final Rule by requiring creditors to verify information relied on in considering each of the specific factors required to be considered under TILA Section 129C(a)(3), which are discussed above in the section-by-section analysis of proposed § 226.43(c)(2).

Proposed § 226.43(c)(3) would implement the general requirement to verify a consumer's repayment ability under TILA Section 129C(a)(1) and requires that creditors verify a consumer's repayment ability using reasonably reliable third-party records, with two exceptions. First, creditors may orally verify a consumer's employment status, if they prepare a record of the oral employment status information. *See* proposed § 226.43(c)(3)(i). The Board believes that creditors in general should use reasonably reliable third-party records to verify information they rely on to determine repayment ability, to document that independent information supports their determination. Based on outreach to several creditors and secondary market investors, however, the Board believes that allowing creditors to verify a consumer's employment status orally may increase the efficiency of the process of verifying employment status without reducing the reliability of the information obtained. Over time, many creditors and secondary market investors have come to allow oral verification of employment status as long as the consumer's employment income is verified using third-party records. The Board is not aware of a reduction in the reliability of employment status information as a result of the shift from written to oral verification of employment status. Also, some employers may prefer to orally verify a consumer's employment status, for example, because of efficiency considerations or concerns about appearing to commit to continuing to employ the consumer. Proposed § 226.43(c)(3)(ii) does not allow creditors to orally verify a consumer's employment income, however.

The second exception to the requirement to verify repayment ability using third-party records applies in cases where a creditor relies on a consumer's credit report to verify a consumer's current debt obligations, and the consumer's application states a current debt obligation not shown in the consumer's credit report. Under proposed § 226.43(c)(3)(ii), the creditor need not independently verify such current debt obligations. Proposed § 226.43(c)(3)(ii) is consistent with current comment 34(a)(4)(ii)(C)–1 adopted by the Board's 2008 HOEPA Final Rule.

Proposed comment 43(c)(3)–1 explains that records used to verify a consumer's repayment ability under proposed § 226.43(c)(1)(ii) must be specific to the individual consumer. Records regarding average incomes in the consumer's geographic location or average incomes paid by the consumer's employer, for example, would not be specific to the individual consumer and are not sufficient. Proposed comment 43(c)(3)–2 explains that creditors may obtain third-party records from a third-party service provider, as long as the records are reasonably reliable and specific to the individual consumer. Creditors also may obtain third-party records, for example, payroll statements, directly from the consumer. Proposed comments 43(c)(3)–1 and –2 are consistent with current commentary and the supplementary information discussing how creditors may obtain records relied on to determine repayment ability under the Board's 2008 HOEPA Final Rule. *See* comments 34(a)(4)(ii)(A)–1, –2, and –4; 73 FR 44522, 44547, July 30, 2008 ("Creditors may [* * *] rely on third party documentation the consumer provides directly to the creditor.")

The Board solicits comment on whether any documents or records prepared by the consumer and not reviewed by a third party appropriately can be considered in determining repayment ability, for example, because a particular record provides information not obtainable using third-party records. In particular, the Board solicits comment on methods currently used to ensure that documents prepared by self-employed consumers (such as a year-to-date profit and loss statement for the period after the period covered by the consumer's latest income tax return, or an operating income statement prepared by a consumer whose income includes rental income) are reasonably reliable for use in determining repayment ability.

43(c)(4) Verification of Income or Assets

TILA Section 129C(a)(4) requires that creditors verify amounts of income or assets relied upon to determine repayment ability by reviewing the consumer's Internal Revenue Service (IRS) Form W–2, tax returns, payroll statements, financial institution records, or other third-party documents that provide reasonably reliable evidence of the consumer's income or assets. TILA Section 129C(a)(4) provides further that, to safeguard against fraudulent reporting, creditors must consider either (1) IRS transcripts of tax returns or (2) an alternative method that quickly and effectively verifies third-party income documentation, subject to rules prescribed by the Board. TILA Section 129C(a)(4) is substantially similar to § 226.34(a)(4)(ii)(A), adopted by the Board's 2008 HOEPA Final Rule. However, TILA Section 129C(a)(4)(B) provides for the alternative methods of third-party income documentation (other than use of an IRS tax-return transcript) to be both "reasonably reliable" and to "quickly and effectively" verify a consumer's income. The Board proposes to adjust the requirement that such alternative method "quickly and effectively" verify a consumer's income. *See* TILA Section 129C(a)(4)(B). Specifically, the Board proposes to implement TILA Section 129C(a)(4) without using the phrase "quickly and effectively" and instead to (1) require the use of third-party records that are reasonably reliable; and (2) provide examples of reasonably reliable records that creditors can use to efficiently verify income, as well as assets. *See* proposed § 226.43(c)(4).

The Board proposes this approach pursuant to the Board's authority under TILA Section 105(a) to prescribe regulations that contain such additional requirements, classifications, differentiations, or other provisions or provide for such adjustments and exceptions for all or any class of transactions as in the judgment of the Board are necessary or proper to effectuate the purposes of TILA, prevent circumvention or evasion thereof, or to facilitate compliance therewith. 15 U.S.C. 1604(a). This approach is further supported by the Board's authority under TILA Section 129B(e) to condition terms, acts or practices relating to residential mortgage loans that the Board finds necessary or proper to effectuate the purposes of TILA. 15 U.S.C. 1639b(e). One of the purposes of TILA Section 129C is to assure that consumers are offered and receive covered transactions on terms that reasonably reflect their ability to repay the loan. *See* TILA Section 129B(a)(2). The Board believes that considering reasonably reliable records is an effective means of verifying a consumer's income and helps ensure that consumers are offered and receive loans on terms that reasonably reflect their repayment ability. The Board believes further that TILA Section 129C(a)(4) is intended to safeguard against fraudulent reporting, rather than to speed the process of verifying a consumer's income. Indeed, there is a risk that requiring that creditors use quick methods to verify the consumer's income would undermine the effectiveness of the ability-to-repay requirement by sacrificing speed for thoroughness. The Board believes that, by contrast, requiring the use of reasonably reliable records effectuates the purposes of TILA Section 129C(a)(4) without suggesting that creditors must obtain records or complete income verification within a specific period of time. The Board also believes that providing examples of reasonably reliable records creditors may use to efficiently verify income or assets facilitates compliance by providing clear guidance to creditors. In addition, providing examples of such records is consistent with TILA Section 129C(a)(4)(B), which authorizes the Board to prescribe the types of records that can be used to quickly and effectively verify a consumer's income.

Proposed § 226.43(c)(4) implements TILA Section 129C(a)(4) and provides that a creditor must verify the amounts of income or assets it relies on to determine a consumer's ability to repay a covered transaction using third-party records that provide reasonably reliable evidence of the consumer's income or assets. The proposed rule and associated commentary provide the following examples of third-party records creditors may use to verify the consumer's income or assets, in addition to or instead of tax-return transcripts issued by the IRS: (1) Copies of tax returns the consumer filed with the IRS or a state taxing authority; (2) IRS Form W–2s or similar IRS forms for reporting wages or tax withholding; (3) payroll statements, including military Leave and Earnings Statements; (4) financial institution records; (5) records from the consumer's employer or a third party that obtained consumer-specific income information from the consumer's employer; (6) records from a government agency stating the consumer's income from benefits or entitlements, such as a "proof of income" letter issued by the Social Security Administration; (7) check cashing receipts; and (8) receipts from a consumer's use of funds transfer services. *See* proposed § 226.43(c)(4)(i)–(viii); proposed comment 43(c)(4)(vi)–1. Those examples are illustrative, not exhaustive, and creditors may determine that other records provide reasonably reliable evidence of the income relied upon in determining a consumer's repayment ability.

Creditors need consider only the income or assets relied upon to determine the consumer's repayment ability, as discussed above in the section-by-section analysis of proposed § 226.43(c)(2)(i). *See* proposed comment 43(c)(2)(i)–2. Accordingly, proposed comment 43(c)(4)–1 clarifies that creditors need verify only the income or assets relied upon to determine the consumer's repayment ability. Proposed comment 43(c)(4)–1 also provides an example where the creditor need not verify a consumer's annual bonus because the creditor relies on only the consumer's salary to determine the consumer's repayment ability. Proposed comment 43(c)(4)–2 clarifies that, if multiple consumers apply jointly for a loan and each lists income or assets on the application, the creditor need verify only the income or assets the creditor relies on to determine repayment ability. Proposed comment 43(c)(4)–3 clarifies that creditors may verify a consumer's income using an IRS tax-return transcript that summarizes the information in the consumer's filed tax return, another record that provides reasonably reliable evidence of the consumer's income, or both. Proposed comment 43(c)(4)–3 also clarifies that creditors may obtain a copy of an IRS tax-return transcript or filed tax return from a service provider or the consumer and need not obtain the copy directly from the IRS or other taxing authority, and cross-references guidance on obtaining records in proposed comment 43(c)(3)–2. Proposed comments 43(c)(4)–1, –2, and –3 are consistent with current commentary adopted by the Board's 2008 HOEPA Final Rule. *See* comments 34(a)(4)–7, 34(a)(4)(ii)(A)–1 and –2. Proposed comment 43(c)(4)(vi)–1 clarifies that an example of a record from a Federal, state, or local government agency stating the consumer's income from benefits or entitlements is a "proof of income letter" (also known as a "budget letter," "benefits letter," or "proof of award letter") from the Social Security Administration.

The Board generally solicits comment on this approach. In addition, the Board specifically solicits comment on whether, consistent with the Board's 2008 HOEPA Final Rule, the Board should provide an affirmative defense for a creditor that can show that the amounts of the consumer's income or assets relied upon in determining the consumer's repayment ability were not materially greater than the amounts the creditor could have verified using third-party records at or before consummation. *See* § 226.34(a)(4)(ii)(B).

43(c)(5) Payment Calculation

Background

Requirements of TILA Sections 129C(a)(1), (3) and (6)

The Board proposes § 226.43(c)(5) to implement the payment calculation requirements of TILA Section 129C(a), as enacted by Section 1411 of the Dodd-Frank Act. TILA Section 129C(a) contains the general requirement that a creditor determine the consumer's "ability to repay the loan, according to its terms, and all applicable taxes, insurance (including mortgage guarantee insurance), and assessments," based on several considerations, including "a payment schedule that fully amortizes the loan over the term of the loan." TILA Sections 129C(a)(1) and (3). The statutory requirement to consider mortgage-related obligations, as defined under proposed § 226.43(b)(8), is discussed above in the section-by-section analysis for proposed § 226.43(c)(2)(v).

TILA Sections 129C(a)(6)(A)–(D) also require creditors to make uniform assumptions when calculating the payment obligation for purposes of determining the consumer's repayment ability for the covered transaction. Specifically, TILA Section 129C(a)(6)(D)(i)–(iii) provides that when calculating the payment obligation that will be used to determine whether the consumer can repay the covered transaction, the creditor must use a fully amortizing payment schedule and assume that—

(1) The loan proceeds are fully disbursed on the date the loan is consummated;

(2) the loan is repaid in substantially equal, monthly amortizing payments for principal and interest over the entire term of the loan with no balloon payment; and

(3) the interest rate over the entire term of the loan is a fixed rate equal to the fully-indexed rate at the time of the loan closing, without considering the introductory rate.

The statute defines the term "fully-indexed rate" in TILA Section 129C(a)(7).

TILA Section 129C(a)(6)(D)(ii)(*I*) and (*II*), however, provides two exceptions to the second assumption regarding "substantially equal, monthly payments over the entire term of the loan with no balloon payment" for loans that require "more rapid repayment (including balloon payment)." First, this statutory provision authorizes the Board to prescribe regulations for calculating the payment obligation for loans that require more rapid repayment (including balloon payment), and which have an annual percentage rate that does not exceed a certain rate threshold. TILA Section 129C(a)(6)(D)(ii)(*I*). Second, for loans that "require more rapid repayment (including balloon payment)," and which exceed a certain rate threshold, the statute requires that the creditor use the loan contract's repayment schedule. TILA Section 129C(a)(6)(D)(ii)(*II*). The statute does not define the term "rapid repayment."

The statute also provides three additional clarifications to the assumptions stated above for loans that contain certain features. First, for variable-rate loans that defer repayment of any principal or interest, TILA Section 129C(a)(6)(A) states that for purposes of the repayment ability determination a creditor must use "a fully amortizing repayment schedule." This provision generally reiterates the requirement provided under TILA Section 129C(a)(3) to use a payment schedule that fully amortizes the loan.

Second, for covered transactions that permit or require interest-only payments, the statute requires that the creditor determine the consumers' repayment ability using "the payment amount required to amortize the loan by its final maturity." TILA Section 129C(a)(6)(B).

Third, for covered transactions with negative amortization, the statute requires the creditor to also take into account "any balance increase that may accrue from any negative amortization provision" when making the repayment ability determination. TILA Section 129C(a)(6)(C). The statute does not define the terms "variable-rate," "fully amortizing," "interest-only," or "negative amortization." Proposed § 226.43(c)(5)(i) and (ii) implement these statutory provisions, and are discussed in further detail below.

2008 HOEPA Final Rule

TILA Section 129C(a), as enacted by Section 1411 of the Dodd-Frank Act, largely codifies many aspects of the repayment ability rule under § 226.34(a)(4) of the Board's 2008 HOEPA Final Rule, which the Board is proposing to remove, and extends such requirements to the entire mortgage market regardless of the loan's interest rate. Similar to § 226.34(a)(4), the statutory framework of TILA Section 129C(a) focuses on prescribing the requirements that govern the underwriting process and extension of credit to consumers, rather than dictating which credit terms may or may not be permissible. However, there are differences between TILA Section 129C(a) and the Board's 2008 HOEPA Final Rule with respect to payment calculation requirements.

Current § 226.34(a)(4) does not address how a creditor must calculate the payment obligation for a loan that cannot meet the presumption of compliance under § 226.34(a)(4)(iii)(B). For example, § 226.34(a)(4) does not specify how to calculate the periodic payment required for a negative amortization loan or balloon loan with a term of less than seven years. In contrast, the Dodd-Frank Act lays out a specific framework for underwriting any loan subject to proposed § 226.43(c). In taking this approach, the statutory requirements in TILA Section 129C(a)(6)(D) addressing payment calculation requirements differ from § 226.34(a)(4)(iii) in the following manner: (1) The statute generally premises repayment ability on monthly payment obligations calculated using the fully indexed rate, with no limit on the term of the loan that should be considered for such purpose; (2) the statute permits underwriting loans with balloon payments to differ depending on whether the loan's annual percentage rate exceeds the applicable loan pricing metric, or meets or falls below the applicable loan pricing metric; and (3) the statute expressly addresses underwriting requirements for loans with interest-only payments or negative amortization.

Interagency Supervisory Guidance

As discussed above in Part II.C, in 2006 and 2007 the Board and other Federal banking agencies addressed concerns regarding the increased risk to creditors and consumers presented by loans that permit consumers to defer repayment of principal and sometimes interest, and by adjustable-rate mortgages in the subprime market. The Interagency Supervisory Guidance stated that creditors should determine a consumer's repayment ability using a payment amount based on the fully indexed rate, assuming a fully amortizing schedule. In addition, the 2006 Nontraditional Mortgage Guidance addressed specific considerations for negative amortization and interest-only loans. State supervisors issued parallel statements to this guidance, which most states have adopted. TILA Sections 129C(a)(3) and (6) are generally consistent with this longstanding Interagency Supervisory Guidance, and largely extend the guidance regarding payment calculation assumptions to all loan types covered under TILA Section 129C(a), regardless of loan's interest rate.

The Board's Proposal

The Board proposes § 226.43(c)(5) to implement the payment calculation requirements of TILA Sections 129C(a)(1), (3) and (6) for purposes of the repayment ability determination required under proposed § 226.43(c). Consistent with these statutory provisions, proposed § 226.43(c)(5) does not prohibit the creditor from offering certain credit terms or loan features, but rather focuses on the calculation process the creditor must use to determine whether the consumer can repay the loan according to its terms. Under the proposal, creditors generally would be required to determine a consumer's ability to repay a covered transaction using the fully indexed rate or the introductory rate, whichever is greater, to calculate monthly, fully amortizing payments that are substantially equal, unless a special rule applies. *See* proposed § 226.43(c)(5)(i). For clarity and simplicity, proposed § 226.43(c)(5)(i) would use the terms "fully amortizing payment" and "fully indexed rate," as discussed above under proposed § 226.43(b)(2) and (3), respectively. Proposed comment 43(c)(5)(i)-1 would clarify that the general rule would apply whether the covered transaction is an adjustable-, step-, or fixed-rate mortgage, as those terms are defined in § 226.18(s)(7)(i), (ii), and (iii), respectively.

Proposed § 226.43(c)(5)(ii)(A)–(C) create exceptions to the general rule and provide special rules for calculating the payment obligation for balloon-payment loans, interest-only loans or negative amortization loans, as follows:

Balloon-payment loans. Consistent with TILA Section 129C(a)(6)(D)(ii)(*I*) and (*II*) of the Dodd-Frank Act, proposed § 226.43(c)(5)(ii)(A) provides special rules for covered transactions with a balloon payment that would differ depending on the loan's rate. Proposed § 226.43(c)(5)(ii)(A)(*1*) states that for covered transactions with a balloon payment that are *not* higher-priced covered transactions, the creditor must determine a consumer's ability to repay the loan using the maximum payment scheduled in the first five years after consummation. Proposed § 226.43(c)(5)(ii)(A)(*2*) further states that for covered transactions with balloon payments that *are* higher priced covered transactions, the creditor must determine the consumer's ability to repay according to the loan's payment schedule, including any balloon payment. For clarity, proposed § 226.43(c)(5)(ii)(A) would use the term "higher-priced covered transaction" to refer to a loan that exceeds the applicable loan rate threshold, and is defined in proposed § 226.43(b)(4), discussed above. The term "balloon payment" has the same meaning as in current § 226.18(s)(5)(i).

Interest-only loans. Consistent with TILA Sections 129C(a)(6)(B) and (D) of the Dodd-Frank Act, proposed § 226.43(c)(5)(ii)(B) provides special rules for interest-only loans. Proposed § 226.43(c)(5)(ii)(B) requires that the creditor determine the consumer's ability to repay the interest-only loan using (1) the fully indexed rate or the introductory rate, whichever is greater; and (2) substantially equal, monthly payments of principal and interest that will repay the loan amount over the term of the loan remaining as of the date the loan is recast. For clarity, proposed § 226.43(c)(5)(ii)(B) would use the terms "loan amount" and "recast," which are defined and discussed under proposed § 226.43(b)(5) and (11), respectively. The term "interest-only loan" has the same meaning as in current § 226.18(s)(7)(iv).

Negative amortization loans. Consistent with TILA Sections 129C(a)(6)(C) and (D) of the Dodd-Frank Act, proposed § 226.43(c)(5)(ii)(C) provides special rules for negative amortization loans. Proposed § 226.43(c)(5)(ii)(C) requires that the creditor determine the consumer's ability to repay the negative amortization loan using (1) the fully indexed rate or the introductory rate, whichever is greater; and (2) substantially equal, monthly payments of principal and interest that will repay the maximum loan amount over the term of the loan remaining as of the date the loan is recast. Proposed comment 43(c)(5)(ii)(C)–1 clarifies that for purposes of this proposed rule, the creditor must first determine the maximum loan amount and the period of time that remains in the loan term after the loan is recast. For clarity, proposed § 226.43(c)(5)(ii)(C) would use the terms "maximum loan amount" and "recast," which are defined and discussed under proposed § 226.43(b)(7) and (11), respectively. The term "negative amortization loan" has the same meaning as in current § 226.18(s)(7)(v) and comment 18(s)(7)(v)–1.

Each of these proposed payment calculation provisions is discussed in greater detail below.

43(c)(5)(i) General rule

Proposed § 226.43(c)(5)(i) implements the payment calculation requirements in TILA Sections 129C(a)(3) and (6)(D)(i)–(iii), and states the general rule for calculating the payment obligation on a covered transaction for purposes of the ability-to-repay provisions. Consistent with the statute, proposed § 226.43(c)(5)(i) provides that unless an exception applies under proposed § 226.43(c)(5)(ii), a creditor must make the repayment ability determination required under proposed § 226.43(c)(2)(iii) by using the greater of the fully indexed rate or any introductory interest rate, and monthly, fully amortizing payments that are substantially equal. That is, under this proposed general rule the creditor would calculate the consumer's monthly payment amount based on the loan amount, and amortize that loan amount in substantially equal payments over the loan term, using the fully indexed rate.

Proposed comment 43(c)(5)(i)–1 would explain that the payment calculation method set forth in § 226.43(c)(5)(i) applies to any covered transaction that does not have a balloon payment, or that is not an interest-only loan or negative amortization loan, whether it is a fixed-rate, adjustable-rate or step-rate mortgage. This comment would further explain that the payment calculation method set forth in § 226.43(c)(5)(ii) applies to any covered transaction that is a loan with a balloon payment, interest-only loan, or negative amortization loan. To facilitate compliance, this comment would list the defined terms used in proposed § 226.43(c)(5) and provide cross-references to their definitions.

The fully indexed rate or introductory rate, whichever is greater. Proposed § 226.43(c)(5)(i)(A) implements the requirement in TILA Section 129C(a)(6)(D)(iii) to use the fully indexed rate when calculating the monthly, fully amortizing payment for purposes of the repayment ability determination. Proposed § 226.43(c)(5)(i)(A) would also provide that when creditors calculate the monthly, fully amortizing payment for adjustable-rate mortgages, they must use the introductory interest rate if it is greater than the fully indexed rate (*i.e.,* a premium rate). In some adjustable-rate transactions, creditors may set an initial interest rate that is not determined by the index or formula used to make later interest rate adjustments. Typically, this initial rate charged to consumers is lower than the rate would be if it were determined by using the index plus margin, or formula (*i.e.,* the fully indexed rate). However, an initial rate that is a premium rate is *higher* than the rate based on the index or formula. *See* proposed comment 43(c)(5)(i)–2. Thus, requiring creditors to use only the fully indexed rate would result in creditors underwriting loans that have a "premium" introductory rate at a rate lower than the rate on which the consumer's initial payments would be based. The Board believes requiring creditors to assess the consumer's ability to repay on the initial higher payments better effectuates the statutory intent and purpose.

The Board proposes to require creditors to underwrite the loan at the premium rate if greater than the fully indexed rate for purposes of the repayment ability determination using its authority under TILA Section 105(a). 15 U.S.C. 1604(a). TILA Section 105(a), as amended by Section 1100A of the Dodd-Frank Act, authorizes the Board to prescribe regulations to carry out the purposes of TILA and Regulation Z, to prevent circumvention or evasion, or to facilitate compliance. 15 U.S.C. 1604(a). This approach is further supported by the Board's authority under TILA Section 129B(e) to condition terms, acts or practices relating to residential mortgage loans that the Board finds necessary or proper to effectuate the purposes of TILA. 15 U.S.C. 1639b(e). The stated purpose of TILA Section 129C is to assure that consumers are offered and receive residential mortgage loans on terms that reasonably reflect their ability to repay the loan. TILA Section 129B(b), 15 U.S.C. 1639b. For the reasons discussed above, the Board believes requiring creditors to underwrite the loan to the premium rate for purposes of the repayment ability determination will help to ensure that the consumers are offered, and receive, loans on terms that reasonably reflect their ability to repay, and to prevent circumvention or evasion.

Monthly, fully amortizing payments. For simplicity, proposed § 226.43(c)(5)(i) uses the term "fully amortizing payment" to refer to the statutory requirements that a creditor use a payment schedule that repays the loan assuming that (1) the loan proceeds are fully disbursed on the date of consummation of the loan; and (2) the loan is repaid in amortizing payments for principal and interest over the entire term of the loan. *See* TILA Sections 129C(a)(3) and (6)(D)(i)–(ii). As discussed above, proposed § 226.43(b)(2) defines "fully amortizing payment" to mean a periodic payment of principal and interest that will fully repay the loan amount over the loan term. The terms "loan amount" and "loan term" are defined in proposed § 226.43(b)(5) and (b)(6), respectively, and discussed above.

The statute also expressly requires that a creditor use "*monthly* amortizing payments" for purposes of the repayment ability determination. TILA Section 129C(6)(D)(ii). The Board recognizes that some loan agreements require consumers to make periodic payments with less frequency, for example quarterly or semi-annually. Proposed § 226.43(c)(5)(i)(B) does not dictate the frequency of payment under the terms of the loan agreement, but does require creditors to convert the payment schedule to monthly payments to determine the consumer's repayment ability. Proposed comment 43(c)(5)(i)–3 clarifies that the general payment calculation rules do not prescribe the terms or loan features that a creditor may choose to offer or extend to a consumer, but establishes the calculation method a creditor must use to determine the consumer's repayment ability for a covered transaction. This comment explains, by way of example, that the terms of the loan agreement may require that the consumer repay the loan in quarterly or bi-weekly scheduled payments, but for purposes of the repayment ability determination, the creditor must convert these scheduled payments to monthly payments in accordance with § 226.43(c)(5)(i)(B). This comment would also explain that the loan agreement may not require the consumer to make fully amortizing payments, but for purposes of the repayment ability determination the creditor must convert any non-amortizing payments to fully amortizing payments.

Substantially equal. Proposed comment 43(c)(5)(i)–4 provides additional guidance to creditors for determining whether monthly, fully amortizing payments are "substantially equal." *See* TILA Section 129C(a)(6)(D)(ii). This comment would state that creditors should disregard minor variations due to payment-schedule irregularities and odd periods, such as a long or short first or last payment period. The comment would explain that monthly payments of principal and interest that repay the loan amount over the loan term need not be equal, but that the monthly payments should be substantially the same without significant variation in the monthly combined payments of both principal and interest. Proposed comment 43(c)(5)(i)–4 further explains that where, for example, no two monthly payments vary from each other by more than 1% (excluding odd periods, such as a long or short first or last payment period), such monthly payments would be considered substantially equal for purposes of this proposal. The comment would further provide that, in general, creditors should determine whether the monthly, fully amortizing payments are substantially equal based on guidance provided in § 226.17(c)(3) (discussing minor variations), and § 226.17(c)(4)(i)–(iii) (discussing payment-schedule irregularities and measuring odd periods due to a long or short first period) and associated commentary. The Board solicits comment on operational difficulties that arise by ensuring payment amounts meet the "substantially equal" condition. The Board also solicits comment on whether a 1% variance is an appropriate tolerance threshold.

Examples of payment calculations. Proposed comment § 226.43(c)(5)(i)–5 provides illustrative examples of how to determine the consumer's repayment ability based on substantially equal, monthly, fully amortizing payments as required under proposed § 226.43(c)(5)(i) for a fixed-rate, adjustable-rate and step-rate mortgage. For example, proposed comment 43(c)(5)(i)–5.ii provides an illustration of the payment calculation for an adjustable-rate mortgage with a five-year discounted rate. The example first assumes a loan in an amount of $200,000 has a 30-year loan term. The loan agreement provides for a discounted interest rate of 6% that is fixed for an initial period of five years, after which the interest rate will adjust annually based on a specified index plus a margin of 3%, subject to a 2% annual periodic interest rate adjustment cap. The index value in effect at consummation is 4.5%; the fully indexed rate is 7.5% (4.5% plus 3%). *See* proposed comment 43(c)(5)(i)–5.ii. This proposed comment explains that even though the scheduled monthly payment required for the first five years is $1,199, for purposes of § 226.43(c)(2)(iii) the creditor must determine the consumer's ability to repay the loan based on a payment of $1,398, which is the substantially equal, monthly, fully amortizing payment that will repay $200,000 over 30 years using the fully indexed rate of 7.5%.

The Board recognizes that, although consistent with the statute, the proposed framework would require creditors to underwrite certain loans, such as hybrid ARMs with a discounted rate period of five or more years (*e.g.,* 5/1, 7/1, and 10/1 ARMs) to a more stringent standard as compared to the underwriting standard set forth in proposed § 226.43(e)(2)(v) for qualified mortgages. The Board believes this approach is consistent with the statute's intent to ensure consumers can reasonably repay their loan, and that in both cases consumers' interests are properly protected. *See* TILA Section 129B(a)(2), 15 U.S.C. 1639b(a)(2). To meet the definition of a qualified mortgage, a loan cannot have certain risky terms or features, such as provisions that permit deferral of principal or a term that exceeds 30 years; no similar restrictions apply to loans subject to the ability-to-repay standard. *See* proposed § 226.43(e)(2)(i) and (ii). As a result, the risk of potential payment shock is diminished significantly for qualified mortgages. For this reason, the Board believes maintaining the more lenient statutory underwriting standard for loans that satisfy the qualified mortgage criteria will help to ensure that responsible and affordable credit remains available to consumers. *See* TILA 129B(a)(2), 15 U.S.C. 1639b(a)(2).

Requests for Comment

Loan amount or outstanding principal balance. As noted above, proposed § 226.43(c)(5)(i) is consistent with the statutory requirements regarding payment calculations for purposes of the repayment ability determination. The Board believes the intent of these statutory requirements is to prevent creditors from assessing the consumer's repayment ability based on understated payment obligations, especially when risky features can be present on the loan. However, the Board is concerned that the statute, as implemented in proposed § 226.43(c)(5)(i), would require creditors to determine, in some cases, a consumer's repayment ability using overstated payment amounts because the creditor must assume that the consumer repays the loan amount in substantially equal payments based on the fully indexed rate, regardless of when the fully indexed rate can take effect under the terms of the loan. The Board is concerned that this approach may restrict credit availability, even where consumers are able to demonstrate that they can repay the payment obligation once the fully indexed rate takes effect.

For this reason, the Board solicits comment on whether it should exercise its authority under TILA Sections 105(a) and 129B(e) to provide that the creditor may calculate the monthly payment using the fully indexed rate based on the outstanding principal balance as of the date the fully indexed rate takes effect under the loan's terms, instead of the loan amount at consummation. 15 U.S.C. 1604(a). Under this approach, the creditor would determine the consumer's repayment ability using the largest payment that could occur under the loan's terms based on the fully indexed rate, rather than using monthly, fully amortizing payments that are substantially equal. For example, for loans with a significant introductory rate period of 7 years or longer, it may be reasonable for the creditor to underwrite the consumer by applying the fully indexed rate to the outstanding principal balance at the end of the 7 year introductory period. To illustrate this approach (all amounts are rounded), assume an adjustable-rate mortgage in the amount of $200,000 with a seven-year discounted rate of 6.5%, after which the interest rate will adjust annually to the specified index plus a margin of 3%. The index value at consummation is 4.5%; the fully indexed rate is 7.5%. At the end of the seventh year (after the 84th monthly payment is credited), when the fully indexed rate takes effect, the outstanding principal balance is $180,832. Under this approach, the creditor could underwrite the loan based on the monthly payment of principal and interest of $1,377 to repay the outstanding principal balance of $180,832, instead of the monthly payment of $1,398 to repay the loan amount of $200,000. Such an approach would seem to be consistent with the purpose of TILA Section 129B(a)(2), which is to ensure the consumer can reasonably repay the loan according to its terms. 15 U.S.C. 1639b(a)(2).

Step-rate mortgages. The Board also notes that for purposes of the repayment ability determination, a step-rate mortgage would be subject to the general payment calculation rule under proposed § 226.43(c)(5)(i), or the special rules under proposed § 226.43(c)(5)(ii), if it did not otherwise meet the definition of a "qualified mortgage." *See* proposed comment 43(c)(5)(i)–1. As discussed in proposed § 226.43(b)(3), which defines the term "fully indexed rate" for purposes of the repayment ability determination, the proposed payment calculation requirements would require creditors to determine a consumer's ability to repay a step-rate mortgage using the maximum rate that can occur at any time during the loan term. The Board notes that this approach is consistent with the requirement that the creditor give effect to the largest margin that can apply at any time during the loan term when determining the fully indexed rate. *See* TILA Section 129C(a)(6)(iii) and (7). However, the Board notes that by requiring creditors to use the maximum rate in a step-rate mortgage, the monthly payments used to determine the consumer's repayment ability will be higher than the consumer's actual maximum payment.

The Board is concerned that this approach could restrict credit availability. The Board recognizes that this concern is also present for adjustable-rate mortgages, but notes that a step-rate product differs from an adjustable-rate mortgage in that future interest rate adjustments are known in advance and do not fluctuate over time in accordance with a market index. The Board believes this feature of a step-rate product could mitigate the payment shock risk to the consumer because the exact rate and payment increases would be disclosed to the consumer in advance, with no potential for the payment amounts to be greater depending on market conditions.

On the other hand, the Board recognizes that a step-rate mortgage that does not have a balloon payment, and is not an interest-only or negative amortization loan, can meet the definition of a qualified mortgage if the other underwriting criteria required are also met. As a result, step-rate mortgages that would need to comply with the payment calculation rules under proposed § 226.43(c)(5) may be more likely to be loans that contain a risky feature. The Board solicits comment, and supporting data for alternative approaches, on whether it should exercise its authority under TILA Sections 105(a) and 129B(e) to provide an exception for step-rate mortgages subject to the payment calculation rules in proposed § 226.43(c)(5). For example, should the Board require that creditors underwrite the step-rate mortgage using the maximum rate in the first seven years, ten years, or some other appropriate time horizon? Should the Board similarly require that creditors underwrite an adjustable-rate mortgage using the maximum interest rate in the first seven years or some other appropriate time horizon that reflects a significant introductory rate period?

Safe harbor to facilitate compliance. The Board recognizes that under this proposal, creditors must comply with multiple assumptions when calculating the particular payment for purposes of the repayment ability determination. For example, creditors would need to ensure that the monthly payment amounts are "substantially equal." Creditors would also need to follow different payment calculation rules depending on the type of loan being underwritten (*i.e.,* balloon-payment loan *vs.* a negative amortization loan), as discussed below under proposed § 226.43(c)(5)(ii). The Board is concerned that the complexity attendant to the proposed payment calculation requirements may increase the potential for unintentional errors to occur, making compliance difficult, especially for small creditors that may be unable to invest in advanced technology or software needed to ensure payment calculations are compliant. At the same time, the Board notes that the intent of the statutory framework and this proposal is to ensure consumers are offered and receive loans on terms that they can reasonably repay. Thus, the Board solicits comment on whether it should exercise its authority under TILA Sections 105(a) and 129B(e) to provide a safe harbor for creditors that use the largest scheduled payment that can occur during the loan term to determine the consumer's ability to repay to facilitate compliance with the requirements under proposed

§ 226.43(c)(5)(i) and (ii). 15 U.S.C. 1604(a).

43(c)(5)(ii) Special Rules: Balloon, Interest-Only, and Negative Amortization Loans

Proposed § 226.43(c)(5)(ii) creates exceptions to the general rule under proposed § 226.43(c)(5)(i), and provides special rules in proposed § 226.43(c)(5)(ii)(A)–(C) for loans with a balloon payment, interest-only loans, and negative amortization loans, respectively, for purposes of the repayment ability determination required under proposed § 226.43(c)(2)(iii). In addition to TILA Section 129C(a)(6)(D)(i)–(iii), proposed § 226.43(c)(5)(ii)(A)–(C) implement TILA Sections 129C(a)(6)(B) and (C), and TILA Section 129C(a)(6)(D)(ii)(*I*)-(*II*). Each of these proposed special rules is discussed below.

43(c)(5)(i)(A) Balloon Loans

The statute provides an exception to the requirement that creditors determine a consumer's repayment ability using substantially equal, monthly payments for loans that require "more rapid repayment (including balloon payment)." *See* TILA Section 129C(a)(6)(D)(ii)(*I*) and (*II*). First, the statute authorizes the Board to prescribe regulations for calculating the payment obligation for loans that require more rapid repayment (including balloon payment), and which have an annual percentage rate that does not exceed the average prime offer rate for a comparable transaction by 1.5 or more percentage points for a first-lien transaction, and by 3.5 or more percentage points for a subordinate-lien transaction (*i.e.,* a "prime" loan). *See* TILA Section 129C(a)(6)(D)(ii)(*I*). Second, for loans that "require more rapid repayment (including balloon payment)," and exceed the loan pricing threshold set forth (*i.e.,* a "nonprime" loan), the statute requires that the creditor use the loan contract's repayment schedule. *See* TILA Section 129C(a)(6)(D)(ii)(*II*). The Board interprets these statutory provisions as authorizing the Board to prescribe special payment calculation rules for "prime" balloon loans, as discussed more fully below.

Scope. The scope of loans covered by the phrase "more rapid repayment (including balloon payment)" in TILA Section 129C(a)(6)(D)(ii) is unclear, and the statute does not define the term "rapid repayment." The Board interprets the use of the term "including," which qualifies the phrase "more rapid repayment," as meaning that balloon loans are covered, but that other loan types are also intended to be covered. The Board notes, however, that loans with a balloon payment actually require *less* rapid payment of principal and interest because the amortization period used is much longer than the term, thereby causing the balloon payment of principal and interest at maturity. Thus, the reference to the phrase "including balloon payment" makes it unclear whether the scope of this provision is meant to cover loans that permit, for example, consumers to make initial payments that are not fully amortizing, such as loans with negative amortization, but that later require larger payments of principal and interest, or other loan types.

Outreach participants offered various interpretations of the phrase "more rapid repayment (including balloon payment)." Participants suggested that the loan types that could be covered by the phrase "more repaid repayment" could range from graduated payment mortgages and negative amortization loans (where initial payments do not cover principal and only some interest, and therefore higher payments of principal and interest are required once the loan recasts to require fully amortizing payments), to niche-market balloon-payment loans (where a series of balloon payments are required intermittently throughout the loan), to growth-equity mortgages (where the loan is paid in full earlier than the term used to calculate initial payments required under the payment schedule).

The Board does not believe it is feasible for the phrase "more rapid repayment" to cover all these loan types given that each one has varying terms and features. Thus, the Board is proposing to use its authority under TILA Section 129C(a)(6)(D)(i)(*I*) only with respect to balloon loans. The Board solicits comment on the meaning of the phrase "more rapid repayment" and what loan products should be covered by this phrase. For example, the Board solicits comment on whether the phrase "more rapid repayment" should include any loan where the payments of principal and interest are based on an amortization period that is shorter than the term of the loan during which scheduled payments are permitted. For example, a loan may amortize the loan amount over a 30-year period to determine monthly payment of interest during the first five years, but fully amortizing payments begin after five years, and therefore are amortized over a period of time that is shorter than the term of the loan (*i.e.,* 25 years). The Board further solicits comment on the specific terms and features of loans that would result in "more rapid repayment."

Higher-priced covered transaction. The Board is proposing § 226.43(c)(5)(i)(A)(*1*) and (*2*) to provide special payment calculation rules for a covered transaction with a balloon payment that would differ depending on whether the loan is or is not a higher-priced covered transaction. For purposes of proposed § 226.43(c)(5)(i)(A), the Board would define "higher-priced covered transaction" to mean a covered transaction with an annual percentage rate that exceeds the average prime offer rate for a comparable transaction as of the date the interest rate is set by 1.5 or more percentage points for a first-lien covered transaction, or by 3.5 or more percentage points for a subordinate-lien covered transaction. *See* proposed § 226.43(b)(4).

As noted above under the proposed definition of higher-priced covered transaction, the Board recognizes that "jumbo" loans typically carry a premium interest rate to reflect the increased credit risk and cost associated with lending larger loan amounts to consumers. Such loans are more likely to be considered "higher-priced covered transactions" and as a result, creditors would need to underwrite such loans using the loan's payment schedule, including any balloon payment. *See* proposed § 226.43(c)(5)(i)(A)(*2*), discussed below. The Board is concerned that this would restrict credit availability for consumers in the "jumbo" balloon market. Accordingly, the Board is soliciting comment on whether it should use its authority under TILA Sections 105(a) and 129B(e) to incorporate the special, separate coverage threshold of 2.5 percentage points for "jumbo loans" to permit more jumbo loans to benefit from the special payment calculation rule under proposed § 226.43(c)(5)(ii)(A)(*1*), and also to be consistent with proposed § 226.45(a)(1), which implements rate thresholds for the proposed escrow account requirement and certain appraisal-related requirements. *See* 76 FR 11598, Mar. 2, 2011; 75 FR 66554, Oct. 28, 2010.

The Board further notes under proposed § 226.43(b)(4) that premium interest rates are typically required for loans secured by non-principal dwellings, such as vacation homes, which are covered by this proposal. Accordingly, the Board also solicits comment and supporting data on whether it should exercise its authority under TILA Sections 105(a) and 129B(e) to incorporate a special, separate coverage threshold to address loans secured by non-principal dwellings, and what rate threshold would be appropriate for such loans.

Proposed comment 43(c)(5)(ii)(A)–1 clarifies that for higher-priced covered transactions with a balloon payment, the creditor must consider the consumer's ability to repay the loan based on the payment schedule under the terms of the legal obligation, including any required balloon payment. This comment would explain that for loans with a balloon payment that are *not* higher-priced covered transactions, the creditor should use the maximum payment scheduled during the first five years of the loan following consummation. To facilitate compliance, the comment would cross-reference to the definition of "balloon payment" in current § 226.18(s)(5)(i).

43(c)(5)(ii)(A)(*1*) "Prime" Balloon Loans

Proposed § 226.43(c)(5)(ii)(A)(*1*) requires a creditor to determine a consumer's ability to repay a loan with a balloon payment using the maximum payment scheduled during the first five years after consummation where the loan is *not* a higher-priced covered transaction (*i.e.,* a "prime" loan). This proposed rule would apply to "prime" loans with a balloon payment that have a term of five or more years.

Legal authority. The Board proposes this approach using its authority under TILA Section 129C(a)(6)(D)(ii)(*I*), which authorizes the Board to prescribe regulations for "prime" balloon loans. In addition, TILA Sections 105(a) and 129B(e) authorize the Board to prescribe regulations that are consistent with the purposes of TILA. 15 U.S.C. 1604(a); 15 U.S.C. 1639b(e). One of the purposes of TILA is to "assure that consumers are offered and receive residential mortgage loan on terms that reasonably reflect their ability to repay the loans." TILA Section 129B(a)(2); 15 U.S.C. 1629b(a)(2). The Board believes proposing to require the creditor to use the largest payment that can occur during the first five years after consummation to determine repayment ability helps to ensure that consumers are offered and receive loans on terms that reasonably reflect their ability to repay the loan, and also facilitates compliance.

First five years after consummation. For several reasons, the Board believes that five years is the appropriate time horizon for purposes of determining the consumer's ability to repay a balloon loan. First, the Board believes this approach preserves credit choice for consumers interested in financing options that are based on interest rates more consistent with shorter-term maturities, and therefore typically less expensive than 30-year fixed-rate loans, but that may offer more stability than some adjustable-rate loans. Five-year balloon loans generally offer consumers a fixed rate for the entire term that is lower than the prevailing rate for a 30-year fixed. Consumers may choose this type of loan as short-term financing with the intent to refinance in the near future into a fully amortizing, longer term loan once the consumer's personal finances, market rate conditions, or some other set of facts and circumstances improves. The Board believes that five years is a sufficient period of time for consumers to improve personal finances, for example, and that there is an increased likelihood that a consumer may refinance, move or relocate during such time frame. In contrast, as discussed in proposed § 226.43(f)(1)(iv), balloon loans with terms less than five years, but with extended amortization periods, such as 30 or more years, may prevent consumers from growing equity and therefore, likely present greater credit risk.

Second, the Board notes that using the first five years after consummation to determine the consumer's repayment ability on a "prime" balloon loan is consistent with other proposed repayment ability provisions, and therefore facilitates compliance. For example, proposed § 226.43(d)(5)(ii) and (e)(2)(iv) require the creditor to use the five-year period after consummation for purposes of the determining whether an exception applies to the repayment ability rules for certain refinancings, and when underwriting the loan to meet the qualified mortgage standard, respectively. The Board further notes that the five-year period under proposed § 226.43(e)(2)(iv) implements the statutory requirement that creditors underwrite a loan, for purposes of the qualified mortgage standard, based on the maximum rate permitted during the first five years after consummation, and therefore, reflects the statutory intent that a five-year period is a reasonable period of time to repay a loan. *See* TILA Section 129(b)(2)(A)(v).

Third, the Board also is proposing to require that balloon loans made by creditors in rural or underserved areas have a minimum five-year term to be considered qualified mortgages. *See* proposed § 226.43(f)(1), discussed below. The Board believes it is appropriate for all types of creditors to use the same loan term when determining a consumer's ability to repay a balloon loan to create a more level playing field. The Board recognizes this concern may be mitigated in part by the proposed asset threshold requirement, *see* proposed § 226.43(f)(1)(v)(D), but believes a consistent approach to underwriting balloon loans helps to prevent unintended consequences. For these reasons, the Board believes this approach preserves credit availability and choice of loan products that may offer more favorable terms to consumers, and also facilitates compliance.

In developing the proposed approach for "prime" balloon loans, the Board considered several different alternatives. For example, the Board considered requiring the creditor to determine whether the consumer could refinance the loan before incurring the balloon payment, using a fully amortizing payment based on the then prevailing interest rate for a fixed-rate mortgage with a 30-year term. The Board also considered requiring the creditor to use a fully amortizing payment based on a rate that would be two times the contractual rate offered during the first five years of the loan with the balloon payment. The Board believes both approaches are speculative in nature, and that neither can accurately predict the interest rate that would be available to consumers at the time they may want to refinance. Moreover, the Board believes both approaches would likely overstate the consumer's actual payment obligation for purposes of the repayment ability determination where, for example, the interest rate on a five-year balloon loan is typically lower than the rate offered on a 30-year fixed. For these reasons, the Board did not believe these approaches were appropriate.

The Board notes that the proposed five-year horizon for purposes of determining the consumers repayment ability for a "prime" balloon loan does not parallel the time horizon used for balloon loans under the Board's anti-steering provisions regarding loan originator compensation. *See* 75 FR 58509, Sept. 24, 2010. The Board's anti-steering rules prohibit a loan originator from steering or directing a consumer to a loan to earn more compensation, unless the transaction is in the consumer's interest. *See* current § 226.36(e). The Board provides a safe harbor for loan originators if certain conditions are met, including offering certain loan options to the consumer. One such loan option must be a loan with no risky features; a balloon payment that occurs in the first 7 years of the life of the loan is deemed a risky feature for this purpose. The Board believes the different approaches are warranted by the different purposes served by the respective rules. Although the anti-steering provisions help to ensure consumers' are offered certain loan options for which they likely qualify, they are primarily intended to prevent loan originators from offering loan options with features that may not benefit the consumer, or that the consumer may not want or need, but which yield the loan originator greater compensation. In contrast, the proposed repayment ability provisions are meant to help ensure that the loan offered or chosen by the consumer has terms that the consumer can reasonably repay.

The Board solicits comment on whether the five-year term is an appropriate time horizon, with supporting data for any alternative approaches.

Proposed comment § 226.43(c)(5)(ii)(A)(*1*)–2 provides further guidance to creditors on determining whether a balloon payment occurs in the first five years after consummation. This comment would clarify that in considering the consumer's repayment ability for a balloon loan that is not a higher-priced covered transaction, the creditor must use the maximum payment scheduled during the first five years, or first 60 months, of the loan after the date of consummation. This comment would provide an illustrative example that assumes a loan with a balloon payment due at the end of a five-year loan term is consummated on August 15, 2011. The first monthly payment is due on October 1, 2011. The first five years after consummation occurs on August 15, 2016, with a balloon payment required on the due date of the 60th monthly payment, which is September 1, 2016. This comment would conclude that in this example, the creditor does not need to consider the balloon payment when determining the consumer's ability to repay this loan.

Proposed comment 43(c)(5)(ii)(A)(*1*)–3 addresses renewable balloon loans. This comment recognizes balloon loans that are not higher-priced covered transactions which provide an unconditional obligation to renew a balloon loan at the consumer's option or obligation to renew subject to conditions within the consumer's control. This comment would clarify that for purposes of the repayment ability determination, the loan term does not include the period of time that could result from a renewal provision. This comment would provide the following illustration to provide further clarification: Assume a 3-year balloon loan that is not a higher-priced covered transaction contains an unconditional obligation to renew for another three years at the consumer's option. In this example, the loan term for the balloon loan is 3 years, and not the potential 6 years that could result if the consumer chooses to renew the loan. Accordingly, the creditor must underwrite the loan using the maximum payment scheduled in the first five years after consummation, which includes the balloon payment due at the end of the 3-year loan term. This comment would cross-reference proposed comment 43(c)(5)(ii)(A).ii, which provides an example of how to determine the consumer's repayment ability for a 3-year renewable balloon loan, and comment 17(c)(1)–11 for a discussion of renewable balloon payment loans.

The Board recognizes that proposed comment 43(c)(5)(ii)(A)(*1*)–3 does not take the same approach as guidance contained in comment 17(c)(1)–11 regarding treatment of renewable balloon loans for disclosure purposes, or with guidance contained in current comment 34(a)(4)(iv)–2 of the Board's 2008 HOEPA Final Rule. Current comment 17(c)(1)–11 states that creditors may make the required TILA disclosures based on a period of time that accounts for any unconditional obligation to renew (*i.e.,* the payment amortization period), assuming the interest rate in effect at the time of consummation. Comment 34(a)(4)(iv)–2, which the Board is proposing to remove, provides that where the creditor is unconditionally obligated to renew the balloon loan, the full term resulting from such renewal is the relevant term for purposes of the exclusion of certain balloon-payment loans from the ability-to-repay presumption of compliance.

Although the proposal differs from current guidance in Regulation Z, the Board believes this approach is appropriate for several reasons. First, the ability-to-repay provisions in the Dodd-Frank Act do not address extending the term of a balloon loan with an unconditional obligation to renew provision. Second, permitting short-term "prime" balloon loans to benefit from the special payment calculation rule when a creditor includes an unconditional obligation to renew, but retains the right to increase the interest rate at the time of renewal, would create a significant loophole in the balloon payment rules. Such an approach could frustrate the objective to ensure consumers obtain mortgages on affordable terms for a reasonable period of time because the interest rate could escalate within a short period of time, increasing the potential risk of payment shock to the consumer. This is particularly the case where no limits exist on the interest rate that the creditor can choose to offer to the consumer at the time of renewal. TILA Section 129B(a)(2), 15 U.S.C. 1639b(a)(2), and TILA Section 129C(b)(2)(A)(v). Moreover, the Board believes it would be speculative to posit the interest rate at the time of renewal for purposes of the repayment ability determination. Third, the guidance contained in comment 17(c)(1)–11 regarding treatment of renewable balloon loans is to help ensure consumers are aware of their loan terms and avoid the uninformed use of credit, which differs from the stated purpose of this proposed provision which is to help ensure that consumers receive loans on terms that reasonably reflect their repayment ability. TILA Section 102(a), 15 U.S.C. 1601(a)(2), and TILA Section 129B(a)(2), 15 U.S.C. 1639b(a)(2).

At the same time, the Board recognizes that small creditors with limited capital and reserves may use these short-term balloon loans with unconditional obligations to renew to hedge their market rate risk. Not treating renewable balloon loans in the same manner as comment 17(c)(1)–11 could restrict credit access to "prime" balloon loans. Accordingly, the Board solicits comment on whether creditors should be able to treat the loan term of a "prime" balloon loan with an unconditional obligation to renew as extended by the renewal provision for purposes of proposed § 226.43(c)(5)(ii)(A), subject to certain conditions. Specifically, the Board solicits comment on how to ensure consumers can reasonably repay the loan on its terms at the time of renewal. The Board further solicits comment on methods to address the risk of circumvention and potential payment shock risk to consumers where creditors are able to unilaterally increase the interest rate at the time of renewal. For example, should the Board permit loan terms to be extended by renewal provisions for purposes of proposed § 226.43(c)(5)(ii)(A) when the creditor underwrites the "prime" balloon loan based on an average fully indexed rate for a comparable transaction?

Proposed 226.43(c)(5)(ii)(A)(*1*)–4 would provide several illustrative examples of how to determine the maximum payment scheduled during the first five years after consummation for loans with a balloon payment that are not higher-priced covered transactions. For example, this comment would illustrate the payment calculation rule for a balloon payment loan with a five-year loan term and fixed interest rate. This comment would assume that a loan provides for a fixed interest rate of 6%, which is below the APOR threshold for a comparable transaction, and thus the loan is not a higher-priced covered transaction. The comment would further assume that the loan amount is $200,000, and that the loan has a five-year loan term but is amortized over 30 years. The loan is consummated on March 15, 2011, and the monthly payment scheduled for the first five years following consummation is $1,199, with the first monthly payment due on May 1, 2011. The first five years after consummation end on March 15, 2016. The balloon payment of $187,308 is required on the due date of the 60th monthly payment, which is April 1, 2016 (more than five years after consummation). *See* proposed comment 226.43(c)(5)(ii)(A)(*1*)–4.iii. This comment explains that for purposes of § 226.43(c)(2)(iii), the creditor must determine the consumer's ability to repay the loan based on the monthly payment of $1,199, and need not consider the balloon payment of $187,308 due on April 1, 2016.

43(c)(5)(ii)(A)(*2*) "Non-Prime" Balloon Loans

Proposed § 226.43(c)(5)(ii)(A)(*2*) implements TILA Section 129C(a)(6)(D)(ii)(*II*) and provides that for a higher-priced covered transaction, the creditor must determine the consumer's ability to repay a loan with a balloon payment using the scheduled payments required under the terms of the loan, including any balloon payment. TILA Section 129C(a)(6)(D)(ii)(*II*) states that for loans that require more rapid repayment (including balloon payment), and which exceed the loan pricing threshold set forth, the creditor must underwrite the loan using the "[loan] contract's repayment schedule." The Board interprets the statutory requirement that the creditor use "the loan contract's payment schedule" to mean that the creditor must use all scheduled payments under the terms of the loan needed to fully amortize the loan, consistent with the requirement under TILA Section 129C(a)(3). Payment of the balloon payment, either at maturity or during at any intermittent period, is necessary to fully amortize the loan. The proposed rule would apply to "non-prime" loans with a balloon payment regardless of the length of the term or any contract provision that provides for an unconditional guarantee to renew. The Board is concerned that this approach could lessen credit choice for non-prime borrowers, restrict credit availability and negatively impact competition for this credit market. Accordingly, the Board solicits comment, with supporting data, on the impact of this approach for low-to-moderate income borrowers. In addition, under proposed § 226.43(c)(2), the creditor would be required to determine that the consumer has a reasonable ability to repay the loan, including the balloon payment, from current or reasonably expected income or assets other than the value of the dwelling. As a result, the creditor would not be able to consider the consumer's ability to refinance the loan in order to pay, or avoid, the balloon payment. The Board requests comment on this approach.

Proposed comment § 226.43(c)(5)(ii)(A)(*2*)–5 provides an illustrative example of how to determine the consumer's repayment ability based on the loan contract's payment schedule, including any balloon payment, for higher-priced covered transactions with a balloon payment. This comment would provide an illustrative example for a balloon payment loan with a 10-year loan term; fixed interest rate. This comment would assume that the loan is a higher-priced covered transaction with a fixed interest rate of 7%. This comment would also assume that the loan amount is $200,000 and the loan has a 10-year loan term, but is amortized over 30 years. This comment would state that the monthly payment scheduled for the first ten years is $1,331, with a balloon payment of $172,956. This comment would explain that for purposes of § 226.43(c)(2)(iii), the creditor must consider the consumer's ability to repay the loan based on the payment schedule that repays the loan amount, including the balloon payment of $172,956.

43(c)(5)(i)(B) Interest-Only Loans

For interest-only loans (*i.e.,* loans that permit interest only payments for any part of the loan term), proposed § 226.43(c)(5)(ii)(B) provides that the creditor must determine the consumer's ability to repay the interest-only loan using (1) the fully indexed rate or any introductory rate, whichever is greater; and (2) substantially equal, monthly payments of principal and interest that will repay the loan amount over the term of the loan remaining as of the date the loan is recast. The proposed payment calculation rule for interest-only loans parallels the general rule proposed in § 226.43(c)(5)(i), except that proposed § 226.43(c)(5)(ii)(B)(*2*) requires a creditor to determine the consumer's ability to repay the loan amount over the term that remains after the loan is recast, rather than requiring the creditor to use fully amortizing payments, as defined under proposed § 226.43(b)(2).

Proposed § 226.43(c)(5)(ii)(B)(*2*) implements TILA Section 129C(a)(6)(B), which requires that the creditor determine the consumer's repayment ability using "the payment amount required to amortize the loan by its final maturity." For clarity, this proposed rule uses the term "recast," which is defined for interest-only loans as the expiration of the period during which interest-only payments are permitted under the terms of the legal obligation. *See* proposed § 226.43(b)(11). The statute does not define the term "interest-only." For purposes of this proposal, the terms "interest-only loan" and "interest-only" have the same meaning as in § 226.18(s)(7)(iv).[43]

Interest-only loans typically provide a fixed introductory payment period, such as five or ten years, during which the consumer may make payments that pay only accrued interest, but no principal. When the interest-only period expires, the payment amount required under the terms of the loan is the principal and interest payment that will repay the loan amount over the remainder of the loan term. The Board interprets the statutory text in TILA Section 129C(a)(6)(B) as requiring the creditor to determine the consumer's ability to repay an interest-only loan using the monthly principal and interest payment amount needed to repay the loan amount once the interest-only payment period expires, rather than using, for example, an understated monthly principal and interest payment that would amortize the loan over its entire term, similar to a 30-year fixed mortgage. The proposed rule would apply to all interest-only loans, regardless of the length of the interest-only period. The Board believes this approach most accurately assesses the consumer's ability to repay the loan once it begins to amortize; this is consistent with the approach taken for interest-only loans in the Interagency Supervisory Guidance.

Proposed comment 43(c)(5)(ii)(B)–1 would clarify that for loans that permit interest-only payments, the creditor must use the fully indexed rate or introductory rate, whichever is greater, to calculate the substantially equal, monthly payment of principal and interest that will repay the loan amount over the term of the loan remaining as of the date the loan is recast for purposes of the repayment ability determination. This comment would also clarify that under proposed § 226.43(c)(5)(ii)(B), the relevant term of the loan is the period of time that remains after the loan is recast to

[43] *See* 12 CFR 226.18(s)(7)(iv), defining "interest only" to mean that under the terms of the legal obligation, one or more of the periodic payments may be applied solely to accrued interest and not to loan principal, and "interest-only loan" to mean a loan that permits interest-only payments.

require payments that will repay the loan amount. This comment would also explain that for a loan on which only interest and no principal has been paid, the loan amount will be the outstanding principal balance at the time of the recast. To facilitate compliance, this comment would cross-reference to proposed comments 43(b)(3)–1 through –5, which provide further guidance on determining the fully indexed rate on the transaction, and proposed comment 43(c)(5)(i)–4, which provides further guidance on the meaning of "substantially equal." This comment would also provide cross-references to defined terms.

Proposed comment 43(c)(5)(ii)(B)–2 would provide illustrative examples for how to determine the consumer's repayment ability based on substantially equal, monthly payments of principal and interest for interest-only loans. This comment would provide the following illustration of the payment calculation rule for a fixed-rate mortgage with interest-only payments for five years: A loan in an amount of $200,000 has a 30-year loan term. The loan agreement provides for a fixed interest rate of 7%, and permits interest-only payments for the first five years. The monthly payment of $1167 scheduled for the first five years would cover only the interest due. The loan is recast on the due date of the 60th monthly payment, after which the scheduled monthly payments increase to $1414, a monthly payment that repays the loan amount of $200,000 over the 25 years remaining as of the date the loan is recast (300 months). For purposes of § 226.43(c)(2)(iii), the creditor must determine the consumer's ability to repay the loan based on a payment of $1414, which is the substantially equal, monthly, fully amortizing payment that would repay $200,000 over the 25 years remaining as of the date the loan is recast using the fixed interest rate of 7%.

43(c)(5)(i)(C) Negative Amortization Loans

For negative amortization loans, proposed § 226.43(c)(5)(ii)(C) provides that a creditor must determine the consumer's repayment ability using (1) the fully indexed rate or any introductory interest rate, whichever is greater; and (2) substantially equal, monthly payments of principal and interest that will repay the maximum loan amount over the term of the loan remaining as of the date the loan is recast. This proposed payment calculation rule for negative amortization loans parallels the general rule in proposed § 226.43(c)(5)(i), except that proposed § 226.43(c)(5)(ii)(C)(*2*) requires the creditor to use the monthly payment amount that repays the maximum loan amount over the term of the loan that remains after the loan is recast, rather than requiring the creditor to use fully amortizing payments, as defined under proposed § 226.43(b)(2). This proposed rule uses the terms "maximum loan amount" and "recast," which are defined and discussed under proposed § 226.43(b)(7) and (b)(11), respectively. Proposed § 226.43(c)(5)(ii)(C)(*2*) implements the statutory requirement in TILA Section 129C(a)(6)(C) that the creditor consider "any balance increase that may accrue from any negative amortization provision when making the repayment ability determination." The statute does not define the term "negative amortization."

Scope. The Board proposes that the term "negative amortization loan" have the same meaning as set forth in current § 226.18(s)(7)(v) for purposes of the repayment ability determination. The Board recently amended § 226.18(s)(7)(v) to clarify that the term "negative amortization loan" covers a loan, other than a reverse mortgage subject to current § 226.33, that provides for a minimum periodic payment that covers only a portion of the accrued interest, resulting in negative amortization. As defined, the term "negative amortization loan" does not cover other loan types that may have a negative amortization feature, but which do not permit the consumer multiple payment options, such as seasonal income loans.[44] Accordingly, proposed § 226.43(c)(5)(ii)(C) covers only loan products that permit or require minimum periodic payments, such as pay option loans and graduated payment mortgages with negative amortization.

Negative amortization loans typically permit borrowers to defer principal and interest repayment for a fixed period of time, such as five years, or until the principal balance increases to the maximum amount allowed under the terms of the loan (*i.e.,* the negative amortization cap). When the introductory period permitting such minimum periodic payments expires or the negative amortization cap is reached, whichever is earlier, the payment amount required under the terms of the loan is the monthly principal and interest payment that will repay the loan amount, plus any balance increase, over the remaining term of the loan. These loans are also often referred to as "pay option" loans because they offer multiple payment options to the consumer. Similarly, graduated payment mortgages that have negative amortization and fall within the definition of "negative amortization loans" provide for step payments that may be less than the interest accrued for a fixed period of time. The unpaid interest is added to the principal balance of the loan. When the introductory payment period expires, the payment amount required under the terms of the loan is the monthly principal and interest payment that will repay the loan amount, plus any principal balance increase, over the remaining term of the loan. The Board believes covering both types of loans in proposed § 226.43(c)(5)(ii)(C) is consistent with statutory intent to account for the negative equity that can occur when a consumer makes payments that defer some or all principal or interest for a period of time, and to address the impact any potential payment shock may have on the consumer's ability to repay the loan. *See* TILA Section 129C(a)(6)(C).

In contrast, in a transaction that has a negative amortization feature, but which does not provide for minimum periodic payments that permit deferral of some or all principal, the consumer repays the loan with fully amortizing payments in accordance with the payment schedule and therefore, the same potential for payment shock or negative equity does not exist. For example, certain loans are designed to permit borrowers with seasonal income to make periodic payments that repay the loan amount for part of the year, and then to skip payments during certain months. During those months when no payments are made, accrued interest results in an increase in the principal balance. However, when the monthly required payments resume, they are fully amortizing payments that repay the principal and interest accrued during that year. *See* comment 18(s)(7)–1 discussing negative amortization loans, and providing an example of a seasonal income loan that is not covered by the term. Loans not covered by the term "negative amortization loan," but which may have a negative amortization feature, would be subject to the payment calculation requirements under the proposed general rule for purposes of determining the consumer's repayment ability. *See* proposed § 226.43(c)(5)(i). Thus, seasonal income loans and

[44] *See* the 2010 MDIA Interim Final Rule, 75 FR 58470, Sept. 24, 2010, revised by 75 FR 81836, 81840, Dec. 29, 2010, which defines the terms "negative amortization" and "negative amortization loan." The term "negative amortization" means payment of periodic payments that will result in an increase in the principal balance under the terms of the legal obligation. *See* § 226.18(s)(7)(v).

graduated payment mortgages that do not fall within the definition of a "negative amortization loan" would be covered by the general payment calculation rule in proposed § 226.43(c)(5)(i).

For purposes of determining the consumer's ability to repay a negative amortization loan under proposed § 226.43(c)(5)(ii)(C), creditors must make a two-step payment calculation.

Step one: maximum loan amount. Proposed § 226.43(c)(5)(ii)(C) requires that the creditor first determine the maximum loan amount and period of time that remains in the loan term after the loan is recast before determining the consumer's repayment ability on the loan. See proposed comment 43(c)(5)(ii)(C)–1; *see also* proposed § 226.43(b)(11), which defines the term "recast" to mean the expiration of the period during which negatively amortizing payments are permitted under the terms of the legal obligation. Proposed comment 43(c)(5)(ii)(C)–2 would further clarify that recast for a negative amortization loan occurs after the maximum loan amount is reached (*i.e.,* the negative amortization cap) or the introductory minimum periodic payment period expires. *See* proposed comment 43(c)(5)(ii)(C)–2.

As discussed above, proposed § 226.43(b)(7) defines "maximum loan amount" as the loan amount plus any increase in principal balance that results from negative amortization, as defined in § 226.18(s)(7)(v), based on the terms of the legal obligation. Under the proposal, creditors would make the following two assumptions when determining the maximum loan amount: (1) The consumer makes only the minimum periodic payments for the maximum possible time, until the consumer must begin making fully amortizing payments; and (2) the maximum interest rate is reached at the earliest possible time.

As discussed above under the proposed definition of "maximum loan amount," the Board interprets the statutory language in TILA Section 129C(a)(6)(C) as requiring creditors to fully account for any potential increase in the loan amount that may result under the loan's terms where the consumer makes only the minimum periodic payments required. The Board believes the intent of this statutory provision is to help ensure that the creditor consider the consumer's capacity to absorb the increased payment amounts that would be needed to amortize the larger loan amount once the loan is recast. The Board recognizes that the approach taken towards calculating the maximum loan amount requires creditors to assume a "worst-case scenario," but believes this approach is consistent with statutory intent to take into account the greatest potential increase in the principal balance.

Moreover, the Board believes that where negative equity occurs in the loan, it can be more difficult for the consumer to refinance out of the loan because no principal has been reduced; a dropping home value market can further aggravate this situation. In these cases, the consumer is more likely to incur the increased payment obligation once the loan is recast. Accordingly, the Board believes it is appropriate to ensure that the consumer can make these increased payment amounts assuming the maximum loan amount, consistent with the statute. The Board also notes that calculating the maximum loan amount based on these assumptions is consistent with the approach in the 2010 MDIA Interim Final Rule,[45] which addresses disclosure requirements for negative amortization loans, and also the 2006 Nontraditional Mortgage Guidance, which provides guidance to creditors regarding underwriting negative amortization loans.[46] Both the 2010 MDIA Interim Final Rule and the 2006 Nontraditional Mortgage Guidance provide that the loan amount plus any balance increase should be taken into account when disclosing terms or calculating the monthly principal and interest payment obligation, respectively.

As discussed above, comment proposed 43(b)–1 would clarify that in determining the maximum loan amount, the creditor must assume that the consumer makes the minimum periodic payment until any negative amortization cap is reached or until the period permitting minimum periodic payments expires, whichever occurs first. Comment 43(b)–2 would provide further guidance to creditors regarding the assumed interest rate. Comment 43(b)–3 would provide examples illustrating how to calculate the maximum loan amount for negative amortization loans for purposes of proposed § 226.43(c)(5)(ii)(C).

Step two: payment calculation. Once the creditor knows the maximum loan amount and period of time that remains after the loan is recast, the proposed payment calculation rule for negative amortization loans requires the creditor to use the fully indexed rate or introductory rate, whichever is greater, to calculate the substantially equal, monthly payment amount that will repay the maximum loan amount over the term of the loan that remains as of the date the loan is recast. *See* proposed § 226.43(c)(5)(ii)(C)(*1*) and (*2*).

Proposed comment 43(c)(5)(ii)(C)–1 would clarify that creditors must follow this two-step approach when determining the consumer's repayment ability on a negative amortization loan, and would also cross-reference to the following defined terms: "maximum loan amount," "negative amortization loan," "fully indexed rate," and "recast." To facilitate compliance, this comment would also cross-reference to proposed comment 43(c)(5)(i)–4 for further guidance on the "substantially equal" requirement.

Proposed comment 43(c)(5)(ii)(C)–2 would provide further guidance to creditors regarding the relevant term of the loan that must be used for purposes of the repayment ability determination. This comment would explain that the relevant term of the loan is the period of time that remains as of the date the terms of the legal obligation recast. This comment would further explain that the creditor must determine substantially equal, monthly payments of principal and interest that will repay the maximum loan amount based on the period of time that remains after any negative amortization cap is triggered or any period permitting minimum periodic payments expires, whichever occurs first.

Proposed comment 43(c)(5)(ii)(C)–3 would provide illustrative examples of how to determine the consumer's repayment ability based on substantially equal, monthly payments of principal and interest as required under proposed § 226.43(c)(5)(ii)(C) for a negative amortization loan. For example, proposed comment 43(c)(5)(ii)(C)–3.ii would illustrate the payment calculation rule for a graduated payment mortgage with a fixed-interest rate that is a negative amortization loan. This comment would first assume a loan in the amount of $200,000 has a 30-year loan term. Second, the comment assumes that the loan agreement provides for a fixed-interest rate of 7.5%, and requires the consumer to make minimum monthly payments during the first year, with payments increasing 12.5% every year (the annual payment cap) for four years. This comment would state that the payment schedule provides for payments of $943 in the first year, $1061 in the second year, $1194 in the third year, $1343 in the fourth year, and then requires $1511 for the remaining term of the loan. This

[45] *See* 12 CFR 226.18(s)(2)(ii) and comment 18(s)(2)(ii)–2.

[46] *See* 2006 Nontraditional Mortgage Guidance *at* 58614, n.7.

comment would then explain that during the first three years of the loan, the payments are less than the interest accrued each month, resulting in negative amortization. Assuming the minimum payments increase year-to-year up to the 12.5% payment cap, the consumer will begin making payments that cover at least all of the interest accrued at the end of the third year. Thus, the loan is recast on the due date of the 36th monthly payment. The maximum loan amount on that date is $207,659, and the remaining loan term is 27 years (324 months). *See* proposed comment 43(c)(5)(ii)(C)–3.ii.

This comment would conclude that for purposes of the repayment ability determination required in § 226.43(c)(2)(iii), the creditor must determine the consumer's ability- to repay the loan based on a monthly payment of $1497, which is the substantially equal, monthly payment of principal and interest that will repay the maximum loan amount of $207,659 over the remaining loan term of 27 years using the fixed interest rate of 7.5%.

The Board recognizes that the payment calculation requirements, which are consistent with statutory requirements, will sometimes require the creditor to underwrite a graduated payment mortgage using a monthly payment that is *lower* than the largest payment the consumer would be required to pay. For example, as illustrated in proposed comment 43(c)(5)(ii)(C)–3.ii, the creditor would underwrite the loan using a monthly payment of $1497 for purposes of the repayment ability determination, even though the consumer will need to begin making monthly payments of $1511 beginning in the fifth year of the loan. This anomaly occurs because the creditor must assume substantially equal payments over the term of the loan remaining as of the date the loan is recast. As discussed above in relation to step-rate mortgages, the Board solicits comment on whether it should exercise its authority under TILA Sections 105(a) and 129B(e) to require the creditor to use the largest payment scheduled when determining the consumer's ability to repay the loan. 15 U.S.C. 1604(a).

43(c)(6) Payment Calculation for Simultaneous Loans

As discussed above, proposed § 226.43(c)(2)(iv) implements TILA Section 129C(a)(2) and requires that when determining the consumer's repayment ability on a covered transaction, the creditor must consider the consumer's monthly payment on any simultaneous loan that the creditor knows or has reason to know will be made, calculated in accordance with proposed § 226.43(c)(6). Furthermore, as discussed under proposed § 226.43(b)(12), the Board is proposing to use its authority under TILA Sections 105(a) and 129B(e) to broaden the scope of TILA Section 129C(a)(2) to include HELOCs, and define the term "simultaneous loan" accordingly, for purposes of the requirements under proposed § 226.43(c)(2)(iv) and (c)(6). 15 U.S.C. 1604(a).

Proposed § 226.43(c)(6) provides the payment calculation for a simultaneous loan that is a closed-end covered transaction or a HELOC. Specifically, proposed § 226.43(c)(6) requires that the creditor consider the consumer's payment on a simultaneous loan that is: (1) A covered transaction, by following proposed § 226.43(c)(5)(i)–(ii); or (2) a HELOC, by using the periodic payment required under the terms of the plan using the amount of credit that will be drawn at consummation of the covered transaction. That is, with respect to simultaneous loans that are covered transactions (*i.e.,* closed-end loans subject to proposed § 226.43(c)), proposed § 226.43(c)(6)(i) requires the creditor to calculate the payment obligation consistent with the rules that apply to covered transactions under proposed § 226.43(c)(5). Under those proposed rules, the creditor must make the repayment ability determination using the greater of the fully indexed rate or any introductory rate, to calculate monthly, fully amortizing payments that are substantially equal. Under proposed § 226.43(b)(2), a "fully amortizing payment" is defined as a periodic payment of principal and interest that will repay the loan amount over the loan term. Thus, in the case of a simultaneous loan that is a closed-end credit transaction, the payment is based on the loan amount. Typically, in closed-end transactions the consumer is committed to using the entire loan amount because there is full disbursement of funds at consummation. *See* proposed comment 43(b)(5)–1, which discusses the definition of loan amount and clarifies that the amount disbursed at consummation is not determinative for purposes of the payment calculation rules. *See* proposed § 226.43(c)(5) for further discussion of the payment calculation requirements for covered transactions.

By contrast, for a simultaneous loan that is a HELOC, the consumer is generally not committed to using the entire credit line at consummation. The amount of funds drawn on a simultaneous HELOC may differ greatly depending, for example, on whether the HELOC is used as a "piggyback loan" to help towards payment on a home purchase transaction or if the HELOC is opened for convenience to be drawn down at a future time. The Board is concerned that requiring the creditor to underwrite a simultaneous HELOC assuming a full draw on the credit line may unduly restrict credit access, especially in connection with non-purchase transactions (*i.e.,* refinancings), because it would require creditors to assess the consumer's repayment ability using potentially overstated payment amounts. Thus, the Board is proposing under § 226.43(c)(6)(ii) that the creditor calculate the payment for the simultaneous HELOC based on the amount of funds to be drawn by the consumer at consummation of the covered transaction. As discussed in further detail below under proposed comment 43(c)(6)–3, the Board solicits comment on whether this approach is appropriate.

Proposed comment 43(c)(6)–1 states that in determining the consumer's repayment ability for a covered transaction, the creditor must include consideration of any simultaneous loan which it knows or has reason to know will be made at or before consummation of the covered transaction. To facilitate compliance, the comment would cross-reference to proposed comment 43(c)(2)(iv)–2 for further discussion on the standard "knows or has reason to know," and proposed § 226.43(b)(12) for the meaning of the term "simultaneous loan."

Proposed comment 43(c)(6)–2 explains that for a simultaneous loan that is a covered transaction, as that term is defined in proposed § 226.43(b)(1), the creditor must determine a consumer's ability to repay the monthly payment obligation for a simultaneous loan as set forth in § 226.43(c)(5), taking into account any mortgage-related obligations. The comment would provide a cross-reference to proposed § 226.43(b)(8) for the meaning of the term "mortgage-related obligations."

Proposed comment 43(c)(6)–3 clarifies that for a simultaneous loan that is a HELOC, the creditor must consider the periodic payment required under the terms of the plan when assessing the consumer's ability to repay the covered transaction secured by the same dwelling as the simultaneous loan. This comment would explain that under proposed § 226.43(c)(6)(ii), the creditor must determine the periodic payment required under the terms of the plan by considering the actual amount of credit to be drawn by the consumer at or before consummation of the covered transaction. This comment would clarify that the amount 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. This comment would provide the following example: Where the creditor's policies and procedures require the source of downpayment to be verified, and the creditor verifies that a simultaneous loan that is a HELOC will provide the source of downpayment for the first-lien covered transaction, the creditor must consider the periodic payment on the HELOC by assuming the amount to be drawn at consummation is the downpayment amount. The Board recognizes that determining the actual amount to be drawn by the consumer may depend on a number of variables, and may not be readily determined prior to consummation. As discussed more fully below, the Board is soliciting comment on the appropriateness of this approach. Proposed comment 43(c)(6)–3 would further clarify that, in general, the creditor should determine the periodic payment based on guidance in staff commentary to § 226.5b(d)(5), which discusses disclosure of payment terms for HELOCs.

The Board recognizes that consumers may fully draw on available credit immediately after closing on the first-lien loan, which could significantly impact their repayment ability on both the first-lien and second-lien mortgage obligations. Although this risk is present with respect to any credit line available to a consumer post-consummation, unlike credit cards, HELOCs are secured by a consumer's dwelling. Inability to repay the first- or second-lien loan could result in foreclosure and loss of the home. In addition, outreach revealed that creditors take varied approaches to determining the periodic payment they consider when underwriting a simultaneous HELOC, with some participants indicating they assume a full draw and calculate the periodic payment based on the fully indexed rate, and other participants indicating that a 50% draw is assumed and only the minimum periodic payment is considered.

For these reasons, the Board solicits comment on the appropriateness of the approach provided under proposed § 226.43(c)(6)(ii) and comment 43(c)(6)–3 regarding the payment calculation for simultaneous HELOCs, with supporting data for any alternative approaches. Specifically, the Board solicits comment on what amount of credit should be assumed as drawn by the consumer for purposes of the payment calculation for simultaneous HELOCs. For example, should the Board require creditors to assume a full draw (*i.e.,* requested amount to be used) of the credit line, a 50% draw, or some other amount instead of the actual amount to be drawn by the consumer? The Board also solicits comment on whether it would facilitate compliance to provide a safe harbor where creditors assume the full credit line is drawn at consummation.

In addition, as noted above, proposed § 226.43(c)(2)(iv) and (c)(6) do not distinguish between purchase and non-purchase covered transactions when requiring creditors to consider a periodic payment required on a simultaneous loan that is a HELOC for purposes of the repayment ability determination. The Board recognizes, however, that concerns regarding "piggyback loans" may not be as acute with non-purchase transactions (*i.e.,* refinancings) where HELOCs generally are taken against established equity in the home, and are opened concurrently with the refinancing of the first-lien loan for convenience and savings in closing costs. In addition, the Board notes that with respect to simultaneous HELOCs originated in connection with a refinancing, proposed § 226.43(c)(2)(iv) and (c)(6) could be circumvented, or its value diminished significantly, where consumers do not draw on the credit line until after the covered transaction is consummated. Moreover, the Board is concerned that the proposal could encourage creditors and consumers to simply originate HELOCs immediately subsequent to the consummation of a covered transaction that is a refinancing, resulting in lost savings and convenience to consumers. For these reasons, the Board solicits comment, and supporting data, on whether the Board should narrow the requirement under proposed § 226.43(c)(2)(iv) and (c)(6) to require creditors to consider simultaneous HELOCs only in connection with purchase transactions.

43(c)(7) Monthly Debt-to-Income Ratio or Residual Income

As discussed above, proposed § 226.43(c)(2)(vii) implements TILA Section 129C(a)(3) and requires creditors, as part of the repayment ability determination, to consider the consumer's monthly debt-to-income ratio or residual income. Proposed § 226.43(c)(7) provides the definitions and calculations for the monthly debt-to-income ratio and residual income. With respect to the definitions, proposed § 226.43(c)(7)(i)(A) defines the term "total monthly debt obligations" to mean the sum of: The payment on the covered transaction, as required to be calculated by § 226.43(c)(2)(iii) and (c)(5); the monthly payment on any simultaneous loans, as required to be calculated by § 226.43(c)(2)(iv) and (c)(6); the monthly payment amount of any mortgage-related obligations, as required to be considered by § 226.43(c)(2)(v); and the monthly payment amount of any current debt obligations, as required to be considered by § 226.43(c)(2)(vi). Proposed § 226.43(c)(7)(i)(B) defines the term "total monthly income" to mean the sum of the consumer's current or reasonably expected income, including any income from assets, as required to be considered by § 226.43(c)(2)(i) and (c)(4).

With respect to the calculations, proposed § 226.43(c)(7)(ii)(A) requires the creditor to consider the consumer's monthly debt-to-income ratio for purposes of § 226.43(c)(2)(vii) using the ratio of the consumer's total monthly debt obligations to total monthly income. Proposed § 226.43(c)(7)(ii)(B) requires the creditor to consider the consumer's remaining income after subtracting the consumer's total monthly debt obligations from the total monthly income.

Proposed comment 43(c)(7)–1 states that creditors must calculate the consumer's total monthly debt obligations and total monthly income in accordance with the requirements in proposed § 226.43(c)(7). The commentary explains that creditors may look to widely accepted governmental and non-governmental underwriting standards to determine the appropriate thresholds for the debt-to-income ratio or residual income.

Proposed comment 43(c)(7)–2 explains that if a creditor considers both the consumer's debt-to-income ratio and residual income, the creditor may base its repayment ability determination on either the consumer's debt-to-income ratio or residual income, even if the ability-to-repay determination would differ with the basis used. Indeed, the Board does not wish to create an incentive for creditors to consider and verify as few factors as possible in the repayment ability determination.

Proposed comment 43(c)(7)–3 clarifies that creditors may consider compensating factors to mitigate a higher debt-to-income ratio or lower residual income. For example, creditors may consider the consumer's assets other than the dwelling securing the covered transaction, or the consumer's residual income as compensating factors for a higher debt-to-income ratio. The proposed commentary permits creditors to look to widely accepted governmental and non-governmental underwriting standards in determining whether and in what manner to include the compensating factors. The Board solicits comment on whether it should provide more guidance on what compensating factors creditors may consider, and on how creditors may include compensating factors in the repayment ability determination.

Residual income. Except for one small creditor and the U.S. Department of Veterans' Affairs (VA), the Board is not aware of any creditors that routinely use residual income in underwriting, other than as a compensating factor.[47] The VA underwrites its loans to veterans based on a residual income table developed in 1997. The table shows the residual income required for the borrower based on the loan amount, region of the country, and family size. The residual income is calculated by deducting obligations, including Federal and state taxes, from effective income. The Board solicits comment on whether consideration of residual income should account for loan amount, region of the country, and family size. The Board also solicits comment on whether creditors should be required to include Federal and state taxes in the consumer's obligations for purposes of calculating residual income.

Automated underwriting systems. The Board understands that creditors routinely rely on automated underwriting systems. Many of those systems are proprietary and thus lack transparency to the individual creditors using the systems. The Board solicits comment on providing a safe harbor for creditors relying on automated underwriting systems that use monthly debt-to-income ratios, if the system developer certifies that the system's use of monthly debt-to-income ratios in determining repayment ability is empirically derived and statistically sound. The Board also solicits comment on other methods to facilitate creditor reliance on automated underwriting systems, while ensuring that creditors can demonstrate compliance with the rule.

43(d) Refinancing of Non-Standard Mortgages

Introduction

Proposed § 226.43(d) exempts creditors of refinancings under certain limited circumstances from the requirement to verify income and assets in determining whether a consumer has the ability to repay a covered transaction. *See* proposed § 226.43(c)(2)(ii). It also applies a different payment calculation requirement to creditors determining whether a consumer has the ability to repay these special types of refinanced loans. *See* proposed § 226.43(c)(2)(iii), and (c)(5). Proposed § 226.43(d) implements TILA Section 129C(a)(6)(E), which was added to TILA under § 1411 of the Dodd-Frank Act. 15 U.S.C. 1639c(a)(6)(E). As previously noted, Section 1411 of the Dodd-Frank Act amends TILA by adding new Section 129C(a), which requires creditors to determine whether a consumer has a reasonable ability to repay a home mortgage loan before making the loan and sets the parameters for that determination (detailed above in the section-by-section analysis of § 226.43(c)). 15 U.S.C. 1639c(a). TILA Section 129C(a)(6)(E) applies special ability-to-repay provisions to transactions in which a "hybrid loan" is refinanced into a "standard loan" and the following additional conditions are met:

- The "creditor" for the hybrid loan and the standard loan is the "same";
- There is a "reduction" in the consumer's monthly payment from the hybrid loan to the standard loan; and
- The consumer "has not been delinquent on any payment on the existing hybrid mortgage."

15 U.S.C. 1639c(a)(6)(E).

Specifically, "in considering any application for a refinancing," the creditor may—

- Consider the consumer's "good standing on the existing mortgage."
- Consider whether the extension of new credit would prevent a likely default should the original mortgage reset and may give this concern a "higher priority as an acceptable underwriting practice."
- Offer rate discounts and other favorable terms to the consumer that would be available to "new customers with high credit ratings based on [the creditor's] underwriting practice."

TILA Section 129C(a)(6)(E)(i)–(iii); 15 U.S.C. 1639c(a)(6)(E)(i)–(iii).

The Dodd-Frank Act does not define the terms "hybrid loan" or "standard loan." The statute also does not expressly state that a creditor is exempt from the statutory ability to repay requirements in refinancings for which the above conditions are met. To determine the meaning of these provisions, the Board reviewed the Dodd-Frank Act's legislative history; consulted with consumer advocates and representatives of both industry and government-sponsored housing finance enterprises (GSEs); and examined underwriting rules and guidelines for the streamlined refinance programs of private creditors, GSEs and government agencies, as well as for the Home Affordable Modification Program (HAMP). For additional guidance, the Board also considered the Dodd-Frank Act provisions exempting streamlined refinancings under Federal government agency programs. *See* TILA Section 129C(a)(5); 15 U.S.C. 1639c(a)(5).

In the Board's view, both the statutory text and additional research support interpreting TILA Section 129C(a)(6)(E) to mean that creditors of refinancings meeting certain conditions should have greater flexibility to comply with the general ability-to-repay provisions in TILA Section 129C(a) (proposed to be implemented by § 226.43(c)). Accordingly, the proposal: (1) Clarifies the conditions that must be met in home mortgage refinancings to which greater flexibility applies; and (2) provides an exemption for creditors of these refinancings from certain limited criteria required to be considered as part of the general repayment ability determination under TILA Section 129C(a) (*see* proposed § 226.43(c)).

Under the proposal, loans that can result in "payment shock" may be refinanced without the creditor having to verify the borrower's income and assets with written documentation as prescribed in the general ability-to-repay requirements (*see* the section-by-section analysis of § 226.43(c)(2)(ii) and (c)(4)), as long as a number of additional conditions are met. In addition, the creditor is permitted to calculate the monthly payment used for determining the consumer's ability to repay the new loan based on assumptions that would typically result in a lower monthly payment than those required to be used under the general ability-to-repay requirements (*see* the section-by-section analysis of § 226.43(c)(2)(iii) and (c)(5)). As a result, when all of the special refinancing conditions are met, creditors may be better able to qualify a consumer for a new loan than under the general ability-to-repay requirements.

A central provision of TILA Section 129C(a)(6)(E) permits creditors to give prevention of a "likely default should the original mortgage reset a higher priority as an acceptable underwriting practice." TILA Section 129C(a)(6)(E)(ii); 15 U.S.C. 1639c(a)(6)(E)(ii). The Board believes that the structure of the statute supports interpreting this provision to mean that certain ability-to-repay criteria under TILA Section 129C(a) should not apply to refinances that meet

[47] *See also,* Michael E. Stone, *What is Housing Affordability? The Case for the Residual Income Approach,* 17 Housing Policy Debate 179 (Fannie Mae 2006) (advocating use of a residual income approach but acknowledging that it "is neither well known, particularly in this country, nor widely understood, let alone accepted").

the requisite conditions. The special refinancing provisions of TILA Section 129C(a)(6)(E) are part of TILA Section 129C(a), entitled "Ability to Repay," the paragraph that specifically prescribes the requirements that creditors must meet to satisfy the obligation to determine a consumer's ability to repay a home mortgage. In the Board's view, the term "underwriting practice" is reasonably interpreted to refer to the underwriting rules prescribed in earlier portions of TILA Section 129C(a)—namely, those concerning the general ability to repay underwriting requirements.

Overall, the Board interprets the special refinancing provisions of TILA Section 129C(a)(6)(E) as intended to allow for the greater flexibility in underwriting that is characteristic of so-called "streamlined refinances." The Board notes in particular that typical streamlined refinance programs do not require documentation of income and assets, although a verbal verification of employment may be required.[48] The Board's interpretation is based both on the statutory text and on the Board's research and outreach with concerned parties.

Regarding the Board's research and outreach, the Board understands that streamlined refinances have been an important resource for consumers, particularly in recent years, who faced impending payment shock, could not qualify for a typical refinance because of property value declines, or both. To address these problems, many lenders as well as the GSEs and government agencies developed lending programs to allow borrowers of loans held by them to refinance despite high loan-to-value ratios or other characteristics that might otherwise impede refinancing. Representatives of creditors and GSEs in particular informed the Board that their streamlined refinance programs are a significant proportion of their portfolios and that they view their programs as valuable to both consumers and loan holders. Consumers are able to take advantage of lower rates to obtain a more affordable loan (and lower payments) and, in some cases, to avoid default or even foreclosure. At the same time, loan holders strengthen their portfolios by replacing potentially unaffordable and unstable loans with affordable, stable products.

Regarding the statutory text, the Board notes that the refinancing provisions under TILA Section 129C(a)(6)(E) include three central elements of typical streamlined refinance programs.[49] First, the creditor for both the existing mortgage and the new mortgage must be the same (see the section-by-section analysis of § 226.43(d)(1)(i) discussing the Board's interpretation of "same creditor" to mean the current holder of the loan or the servicer acting on behalf of the current holder). 15 U.S.C. 1639C(a)(6)(E). Second, the borrower must have a positive payment history on the existing mortgage (see the section-by-section analysis of § 226.43(d)(1)(iv) and (d)(1)(v) for further discussion). Third, TILA's special refinancing provisions require that the payment on the new mortgage be lower than the payment on the existing mortgage—a common objective of typical streamlined refinance programs.[50]

Finally, as noted, TILA Section 129C(a) includes a provision that specifically addresses how the general ability-to-repay requirements apply to streamlined refinances under programs of government agencies such as the Federal Housing Administration and U.S. Department of Veterans' Affairs. *See* TILA Section 129C(a)(5), 15 U.S.C. 1639c(a)(5). In the Board's view, the most reasonable interpretation of the additional section on refinancings under TILA Section 129C(a)(6)(E) is that it is intended to cover the remaining market for streamlined refinances—namely, those offered under programs of private creditors and the GSEs.

One difference between the statute and typical streamlined refinance programs, however, is that the statute targets consumers facing "likely default" if the existing mortgage "reset[s]." The Board understands that, by contrast, streamlined refinance programs are not normally limited to borrowers at risk in this way. For example, they often assist consumers who are not facing potential default but who simply wish to take advantage of lower rates despite a drop in their home value or wish to switch from a less stable variable-rate product to a fixed-rate product.[51] However, the focus of TILA's new refinancing provisions is similar to the focus of HAMP, a government program specifically aimed at providing modifications for borrowers at risk of "imminent default," or in default or foreclosure.[52] Underwriting criteria for a HAMP modification are considerably more stringent than for a typical streamlined refinance; for example, income verification documentation is required, in addition to documented verification of expenses.[53] Concerns about the potential risks posed by loans to troubled borrowers may explain the robust underwriting standards for HAMP modifications.

On balance, the Board believes that the statutory language is most appropriately interpreted to be modeled on the underwriting standards of typical streamlined refinance programs rather than the tighter standards of HAMP. The plain language of the Dodd-Frank Act indicates that Congress intended to facilitate opportunities to refinance loans on which their payments could become significantly higher and thus unaffordable. Applying the strict underwriting standards that are too stringent could impede refinances that Congress intended to encourage. In particular, the statutory language permitting creditors to give "likely default" a "higher priority as an acceptable underwriting practice" indicates that flexibility in these special refinances should be permitted. In addition, underwriting standards that go significantly beyond those used in existing streamlined refinance programs could create a risk that these programs would be unable to meet the TILA ability-to-repay requirements; thus, an important refinancing resource for at-risk borrowers would be compromised and the overall mortgage market potentially disrupted at a vulnerable time.

At the same time, the Board recognizes that borrowers at risk of default when higher payments are required might present greater credit risks to the institutions holding their loans when those loans are refinanced without verifying the consumer's income and assets. For example, a consumer may be paying $525 per month as an interest-only payment on an existing adjustable-rate loan. When refinanced at a lower, fixed rate with fully amortizing payments, however, the

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[48] *See id.* at 4. *See also, e.g.,* Freddie Mac Single-Family Seller/Servicer Guide, Vol. 1, Ch. 24: Refinance Mortgages/24.4: Requirements for Freddie Mac-owned streamlined refinance mortgages (Sept. 1, 2010). As of May 1, 2011, Freddie Mac will no longer purchase Freddie Mac-owned streamlined refinance mortgages. *See* Freddie Mac Bulletin 2011–2 (Jan. 18, 2011).

[49] During outreach, Fannie Mae provided data to the Board indicating that for 2010, Fannie Mae, Freddie Mac and Ginnie Mae refinancings totaled $925 billion, while non-GSE refinancings totaled $73 billion. Of the combined GSE refinancings, $288.6 billion were "streamlined refinances"—approximately one-third of all GSE refinancings.

[50] *See, e.g.,* Fannie Mae, "Home Affordable Refinance Refi Plus™ Options," p. 1 (Mar. 29, 2010).

[51] *See, e.g.,* Fannie Mae, "Home Affordable Refinance Refi Plus™ Options," p. 1 (Mar. 29, 2010); Freddie Mac, "Freddie Mac-owned Streamlined Refinance Mortgage," Pub. No. 387, pp. 1–2 (Aug. 2010).

[52] *See, e.g.,* Fannie Mae, "Home Affordable Modification Program," p. 1, FM 0509 (2009).

[53] *See,* Fannie Mae, "Making Home Affordable℠ Program, Handbook for Servicers of Non-GSE Mortgages," Ch. II, § 5, pp. 59–62 (Dec. 2, 2010).

payment may go up somewhat from the previous interest-only level—for example, to $650—because the new payments now cover both principal and interest. (For further discussion of how this scenario is possible under the proposal, see the section-by-section analysis of proposed § 226.43(d)(5).) The new payment of $650 is likely to be lower than the "reset" payment at the fully-indexed rate on the existing mortgage; nonetheless, the creditor incurs some risk that the consumer may not be able to afford the new payments.

For this reason, to qualify for the ability to repay exemptions under proposed § 226.43(d), a consumer must meet some requirements that are more stringent than those of typical streamlined refinance programs. Under the proposal, for example, a consumer may have had only one delinquency of more than 30 days in the 24 months immediately preceding the consumer's application for a refinance. *See* proposed § 226.43(d)(1)(iv). By contrast, streamlined refinance programs of which the Board is aware tend to consider the consumer's payment history for only the last 12 months.[54] As another safeguard against risk, the Board defines the type of loan into which a consumer may refinance under TILA's new refinancing provisions to include several characteristics designed to ensure that those loans are stable and affordable. These include a requirement that the interest rate be fixed for the first five years after consummation (*see* proposed § 226.43(d)(2)(ii)(D)) and that the points and fees be capped at three percent of the total loan amount, subject to a limited exemption for smaller loans (*see* proposed § 226.43(d)(2)(ii)(B))).

The Board's Proposal

43(d)(1) Scope

Proposed § 226.43(d)(1) defines the scope of the provisions regarding the refinancing of non-standard mortgages under proposed § 226.43(d). Specifically, this provision states that § 226.43(d) applies to the refinancing of a "non-standard mortgage" (defined in proposed § 226.43(d)(2)(i)) into a "standard mortgage" (defined in proposed § 226.43(d)(2)(ii)) when the following conditions are met—

- The creditor of the standard mortgage is the current holder of the existing non-standard mortgage or the servicer acting on behalf of the current holder.
- The monthly payment for the standard mortgage is significantly lower than the monthly payment for the non-standard mortgage, as calculated under proposed § 226.43(d)(5).
- The creditor receives the consumer's written application for the standard mortgage before the non-standard mortgage is "recast" (defined in proposed § 226.43(b)(11)).
- The consumer has made no more than one payment more than 30 days late on the non-standard mortgage during the 24 months immediately preceding the creditor's receipt of the consumer's written application for the standard mortgage.
- The consumer has made no payments more than 30 days late during the six months immediately preceding the creditor's receipt of the consumer's written application for the standard mortgage.

As discussed further below, proposed § 226.43(d)(2)(iii) defines the term "refinancing" to have the same meaning as in § 226.20(a).

Proposed comment 43(d)(1)–1 clarifies that the requirements for a "written application," a term that appears in § 226.43(d)(1)(iii), (d)(1)(iv) and (d)(1)(v), discussed in detail below, are found in comment 19(a)(1)(i)–3. Comment 19(a)(1)(i)–3 states that creditors may rely on the Real Estate Settlement Procedures Act (RESPA) and Regulation X (including any interpretations issued by HUD) in deciding whether a "written application" has been received. This comment further states that, in general, Regulation X defines "application" to mean the submission of a borrower's financial information in anticipation of a credit decision relating to a Federally related mortgage loan. *See* 24 CFR 3500.2(b). The comment clarifies that an application is received when it reaches the creditor in any of the ways applications are normally transmitted—by mail, hand delivery, or through an intermediary agent or broker. The comment further clarifies that, if an application reaches the creditor through an intermediary agent or broker, the application is received when it reaches the creditor, rather than when it reaches the agent or broker. This comment also cross-references comment 19(b)–3 for guidance in determining whether or not the transaction involves an intermediary agent or broker.

43(d)(1)(i) Creditor is the Current Holder or Servicer Acting on Behalf of Current Holder

Proposed § 226.43(d)(1)(i) requires that the creditor for the new mortgage (the "standard mortgage") also be either the current holder of the existing "non-standard mortgage" or the servicer acting on behalf of the current holder. This provision implements the statutory requirement that the existing loan must be refinanced by "the creditor into a standard loan to be made by the same creditor." TILA Section 129C(a)(6)(E); 15 U.S.C. 1639c(a)(6)(E). The Board believes that this statutory provision requires the entity refinancing the loan to have an existing relationship with the consumer. The existing relationship is important because the creditor must be able to easily access the consumer's payment history and potentially other information about the consumer in lieu of documenting the consumer's income and assets. In addition, the Board reads the statute to be intended in part to ensure the safety and soundness of financial institutions by giving them greater flexibility to improve the quality of their loan portfolios through streamlined refinances.

The Board also believes that this statutory provision is intended to ensure that the creditor of the refinancing have an interest in placing the consumer into new loan that is affordable and beneficial. In the Board's view, the creditor of the new loan will in most cases retain an interest in the consumer's well-being when the creditor is also the current holder of the loan or the servicer acting on the current holder's behalf. In cases where a creditor holds a loan and will hold the loan after it is refinanced, the creditor has a direct interest in refinancing the consumer into a more stable and affordable product. In addition, the Board understands that the existing servicer often will be the entity conducting the refinance, particularly for refinances held by GSEs. By also permitting the creditor on the refinanced loan to be the servicer acting on behalf of the holder of the existing mortgage, the proposal is intended clearly to cover instances where a loan that has been sold to a GSE is refinanced by the existing servicer and continues to be held by the same GSE.

At the same time, the Board recognizes that the creditor on the new mortgage may not necessarily retain an interest in the new loan if the creditor immediately sells the loan to a new holder. The Board requests comment on whether the proposed rule could be structured differently to better ensure that the creditor on a refinancing under § 226.43(d) retains an interest in the performance of the new loan and whether additional guidance is needed.

[54] *See, e.g.,* Fannie Mae, "Home Affordable Refinance Refi Plus™ Options," p. 2 (Mar. 29, 2010); Freddie Mac, "Freddie Mac-owned Streamlined Refinance Mortgage," Pub. No. 387, p. 2 (Aug. 2010).

43(d)(1)(ii) Monthly Payment for the Standard Mortgage is Materially Lower Than the Monthly Payment for the Non-Standard Mortgage

Proposed § 226.43(d)(1)(ii) requires that the monthly payment on the new loan (the "standard mortgage") be "materially lower" than the monthly payment for the existing loan (the "non-standard mortgage"). This provision implements the statutory requirement that there be "a reduction in monthly payment on the existing hybrid loan" in order for the special provisions to apply to a refinancing. TILA Section 129C(a)(6)(E); 15 U.S.C. 1639c(a)(6)(E). Proposed comment 43(d)(1)(ii)–1 provides that the exemptions afforded under § 226.43(d)(3) (discussed below) apply to a refinancing only if the monthly payment for the new loan is "materially lower" than the monthly payment for an existing non-standard mortgage and clarifies that the payments that must be compared must be calculated based on the requirements under § 226.43(d)(5) (discussed below). This comment also explains that whether the new loan payment is "materially lower" than the non-standard mortgage payment depends on the facts and circumstances, but that, in all cases, a payment reduction of 10 percent or greater would meet the "materially lower" standard.

For several reasons, the Board interprets the statutory requirement for a "reduction in monthly payment" to mean that the new payment must be "materially lower" than the payment under the existing mortgage and that a 10 percent or greater reduction is a reasonable safe harbor. First, if the required reduction could be merely *de minimis*—such as a reduction of a few cents or dollars—the statutory purpose would not be met. In such cases, the consumer would not obtain a meaningful benefit that would prevent default—in other words, the reduction would not be "material." Second, based on outreach, the Board understands that a 10 percent reduction in the payment is a reasonable minimum reduction that can provide a meaningful benefit to the consumer.

The Board requests comment on whether a requirement that the payment on the standard mortgage must be "materially lower" than the payment on the non-standard mortgage (as calculated under § 226.43(d)(5)(ii) and (d)(5)(i), respectively) and whether a 10 percent reduction or some other percentage or dollar amount would be a more appropriate safe harbor for compliance with this requirement. The Board also requests comment on whether a percentage or dollar amount reduction would be more appropriate a rule rather than a safe harbor.

43(d)(1)(iii) Creditor Receives the Consumer's Written Application for the Standard Mortgage Before the Non-Standard Mortgage is Recast

Proposed § 226.43(d)(1)(iii) requires that the creditor for the refinancing receive the consumer's written application for the refinancing before the existing non-standard mortgage is "recast." As discussed in the section-by-section analysis of § 226.43(b)(11), the Board defines the term "recast" to mean, for an adjustable-rate mortgage, the expiration of the period during which payments based on the introductory fixed rate are permitted; for an interest-only loan, the expiration of the period during which the interest-only payments are permitted; and, for a negative amortization loan, the expiration of the period during which negatively amortizing payments are permitted.

The Board believes that proposed § 226.43(d)(1)(iii) is necessary to implement TILA Section 129C(a)(6)(E)(ii), which permits creditors of certain refinances to "consider if the extension of new credit would prevent a likely default should the original mortgage reset." 15 U.S.C. 1639c(a)(6)(E)(ii). This statutory language implies that the special refinancing provisions apply only where the original mortgage has not yet "reset." Congress's concern appears to be prevention of default in the event of a "reset," not loss mitigation on a mortgage for which a default on the "reset" payment has already occurred.

The Board recognizes that a consumer may not realize that a loan will be recast until the recast occurs and that, at that point, the consumer could not refinance the loan under the special streamlined refinancing provisions of proposed § 226.43(d). The Board requests comment on whether to use its legal authority to make adjustments to TILA to permit streamlined refinancings even after a loan is recast.

43(d)(1)(iv) One Payment More Than 30 Days Late During the 24 Months Immediately Preceding the Creditor's Receipt of the Consumer's Written Application

Proposed § 226.43(d)(1)(iv) requires that, during the 24 months immediately preceding the creditor's receipt of the consumer's written application for the standard mortgage, the consumer has made no more than one payment on the non-standard mortgage more than 30 days late. Together with § 226.43(d)(1)(v) (discussed below), § 226.43(d)(1)(iv) implements the portion of TILA Section 129C(a)(6)(E) that requires that the borrower not have been "delinquent on any payment on the existing hybrid loan." 15 U.S.C. 1639c(a)(6)(E).

The Board believes that the proposal is consistent with the statutory prohibition on "any" delinquencies on the existing non-standard ("hybrid") mortgage, in addition to being consistent with the consumer protection purpose of TILA and industry practices under many current streamlined refinance programs. Further, the proposal is supported by the Board's authority under TILA Sections 105(a) and 129B(e) to adjust provisions of TILA and condition practices "to assure that consumers are offered and receive residential mortgage loan on terms that reasonably reflect their ability to repay the loans and that are understandable and not unfair, deceptive, or abusive." 15 U.S.C. 1604(a); 15 U.S.C. 1639b(e); TILA Section 129B(a)(2), 15 U.S.C. 1639b(a)(2). The proposal is designed to further this purpose by facilitating transactions that help consumers refinance out of unaffordable loans.

During outreach, the Board learned that a delinquency of more than 30 days often can occur at the time of loan set-up due to errors in the set-up process outside of the consumer's control. The Board also noted, as discussed above, that all of the streamlined refinance programs reviewed by the Board permit at least one 30- or 31-day delinquency, although usually during the last 12 months rather than the last 24 months prior to application for a refinancing.[55] Thus the proposal is more stringent than typical streamlined refinance programs, but does not prohibit all delinquencies.

24–Month Look-Back Period. The Board proposes to require a look-back period for payment history of 24 months, rather than a 12-month period, for several reasons. First, as noted earlier, typical streamlined refinance programs are often aimed at helping borrowers with no risk of default. The Board recognizes that borrowers at risk of default when higher payments are required might present greater credit risks to the institutions holding their loans, even if the institutions refinance those loans. In the Board's view, when income and assets are not required to be verified, as proposed, the borrower's payment history takes on greater

[55] *See, e.g.,* Fannie Mae, "Home Affordable Refinance Refi Plus™ Options," p. 2 (Mar. 29, 2010); Freddie Mac, "Freddie Mac-owned Streamlined Refinance Mortgage," Pub. No. 387, p. 2 (Aug. 2010).

importance, especially in dealing with at-risk borrowers.

Second, the Board sees some merit in the views expressed during outreach by GSE and creditor representatives that borrowers with positive payment histories tend to be less likely than other borrowers to sign up for a new loan for which they cannot afford the monthly payments. At the same time, the Board acknowledges that a positive payment history on payments at low levels due to temporarily favorable loan terms is no guaranty that the consumer can afford the payments on a new loan. The Board solicits comment on the proposal to require that the consumer have only one delinquency during the 24 months prior to applying for a refinancing, particularly on whether a longer or shorter look-back period should be required.

Delinquency of 30 days or fewer permitted. Under the proposal, late payments of 30 days or fewer on the existing, non-standard mortgage would not disqualify a consumer from refinancing the non-standard mortgage under the streamlined refinance provisions of proposed § 226.43(d). The Board believes that allowing delinquencies of 30 or fewer days is consistent with the statutory prohibition on "any" delinquency for several reasons. First, delinquencies of this length may occur for many reasons outside of the consumer's control, such as mailing delays, miscommunication about where the payment should be sent, or payment crediting errors. Second, many creditors incorporate a late fee "grace period" into their payment arrangements, which permits consumers to make their monthly payments for a certain number of days after the contractual due date without incurring a late fee. Thus, many consumers regularly make their payments after the contractual due date and may even set up automated withdrawals for their payments to be made after the contractual due date in order to coincide with the consumer's pay periods. The Board does not believe that the statute is reasonably interpreted to prohibit consumers from obtaining needed refinances due to payments that are late but within a late fee grace period.

In addition, as discussed above, the Board interprets TILA Section 129C(a)(6)(E) to be intended as a mechanism for allowing existing streamlined refinance programs to continue should the entities offering them wish to maintain these programs. The predominant streamlined refinance programs of which the Board is aware uniformly measure whether a consumer has a positive payment history based on whether the consumer has made any payments late by 30 days or more (or, as in the proposal, more than 30 days).[56]

Proposed comment 43(d)(1)(iv)–1 provides the following illustration of the rule under § 226.43(d)(1)(iv): Assume a consumer applies for a refinancing on May 1, 2011. Assume also that the consumer made a non-standard mortgage payment on August 15, 2009, that was 45 days late, but made no other late payments on the non-standard mortgage between May 1, 2009, and May 1, 2011. In this example, the requirement under § 226.43(d)(1)(iv) is met because the consumer made only one payment that was over 30 days late within the 24 months prior to applying for the refinancing (*i.e.,* 20 and one-half months prior to application).

Payment due date. Proposed comment 43(d)(1)(iv)–2 clarifies that whether a payment is more than 30 days late depends on the contractual due date not accounting for any grace period. The comment provides the following example: The contractual due date for a non-standard mortgage payment is the first day of every month, but no late fee will be charged as long as the payment is received by the 16th day of the month. Here, the "payment due date" is the first day of the month rather than the 16th day of the month. Thus, a payment due under the contract on September 1st that is paid on October 1st is made more than 30 days after the payment due date.

The Board believes that using the contractual due date for determining whether a payment has been made more than 30 days after the due date will facilitate compliance and enforcement by providing clarity. Whereas late fee "grace periods" are often not stated in writing, the contractual due date is unambiguous. In addition, using the contractual due date for determining whether a loan payment is made on time is consistent with standard home mortgage loan contracts.[57]

The Board requests comment on whether the delinquencies that creditors are required to consider under § 226.43(d)(1) should be late payments of more than 30 days as proposed, 30 days or more, or some other time period.

43(d)(1)(v) No Payments More Than 30 Days Late During the Six Months Immediately Preceding the Creditor's Receipt of the Consumer's Written Application

Proposed § 226.43(d)(1)(v) requires that the consumer have made no payments on the non-standard mortgage more than 30 days late during the six months immediately preceding the creditor's receipt of the consumer's written application for the standard mortgage. This provision is intended to complement proposed § 226.43(d)(1)(iv), discussed above, in implementing the portion of TILA Section 129C(a)(6)(E) that requires that the borrower not have been "delinquent on any payment on the existing hybrid loan." 15 U.S.C. 1639C(a)(6)(E). The Board believes that, together with proposed § 226.43(d)(1)(iv), this aspect of the proposal is a reasonable interpretation of the prohibition on "any" delinquencies on the non-standard mortgage and is supported by the Board's authority under TILA Sections 105(a) and 129B(e) to adjust provisions of TILA and condition practices "to assure that consumers are offered and receive residential mortgage loan on terms that reasonably reflect their ability to repay the loans and that are understandable and not unfair, deceptive, or abusive." 15 U.S.C. 1604(a); TILA Section 129B(a)(2), 15 U.S.C. 1639b(a)(2).

The Board believes that a six-month "clean" payment record indicates a reasonable level of financial stability on the part of the consumer applying for a refinancing. This measure of financial stability is especially important where income and assets are not required to be verified. In addition, some outreach participants indicated that a prohibition on delinquencies of more than 30 days for the six months prior to application for the refinancing was generally consistent with common industry practice and would not be unduly disruptive to existing streamlined refinance programs with well-performing loans.

Proposed comment 43(d)(1)(v)–1 provides the following examples of the proposed rule: Assume a consumer in a non-standard mortgage applies for a refinancing on May 1, 2011. If the consumer made a 45-day late payment on March 15, 2011, the requirement under § 226.43(d)(1)(v) is not met because the consumer made a payment more than 30 days late just one and one-half months prior to application.

[56] *See, e.g.,* Freddie Mac Single-Family Seller/Servicer Guide, Vol. 1, Ch. 24: Refinance Mortgages/24.4: Requirements for Freddie Mac-owned streamlined refinance mortgages (Sept. 1, 2010) (requiring that the consumer has been current on the existing mortgage "for the most recent 90 days and has not been 30 days delinquent more than once in the most recent 21 months, or if the Mortgage being refinanced is seasoned for less than 12 months, since the Mortgage Note Date").

[57] *See* Fannie Mae/Freddie Mac Uniform Instrument, Multistate Fixed Rate Note—Single Family, Form 3200, §§ 3, 6.

The comment further clarifies that if the number of months between consummation of the non-standard mortgage and the consumer's application for the standard mortgage is six or fewer, the consumer may not have made any payment more than 30 days late on the non-standard mortgage. The comment cross-references proposed comments 43(d)(1)–2 and 43(d)(1)(iv)–2 for an explanation of "written application" and how to determine the payment due date, respectively.

43(d)(2) Definitions

Proposed Section 226.43(d)(2) defines the terms "non-standard mortgage" and "standard mortgage" in proposed § 226.43(d). As noted earlier, the statute does not define the terms "hybrid loan" and "standard loan" used in the special refinancing provisions of TILA Section 129C(a)(6)(E). Therefore, the Board proposes definitions that in its view are consistent with the policy objective underlying these special provisions: Facilitating the refinancing of home mortgages on which consumers risk a likely default due to impending payment shock into more stable and affordable products.

43(d)(2)(i) Non-Standard Mortgage

Proposed § 226.43(d)(2)(i) substitutes the term "non-standard mortgage" for the statutory term "hybrid loan" and defines this term to mean a covered transaction on which the loan has a fixed "teaser" rate for a period of one year or longer after consummation, which then adjusts to a variable rate plus a margin for the remaining term of the loan; or the minimum periodic payments (whether required or optional) are either interest-only or negatively amortizing. Specifically, a "non-standard mortgage" is any "covered transaction" (defined in proposed § 226.43(b)(1)) that is:

- An adjustable-rate mortgage, as defined in § 226.18(s)(7)(i), with an introductory fixed interest rate for a period of one year or longer; [58]
- An interest-only loan, as defined in § 226.18(s)(7)(iv); [59] or
- A negative amortization loan, as defined in § 226.18(s)(7)(v).[60]

Proposed comment 43(d)(2)(i)(A)–1 explains what it means that a "non-standard mortgage" includes an adjustable-rate mortgage with an introductory fixed interest rate for one or more years. This comment clarifies that, for example, a covered transaction with a fixed introductory rate for the first two, three or five years and then converts to a variable rate for the remaining 28, 27 or 25 years, respectively, is a "non-standard mortgage." By contrast, a covered transaction with an introductory rate for six months that then converts to a variable rate for the remaining 29 and ½ years is not a "non-standard mortgage."

The Board believes that the proposed definition of a "non-standard mortgage" is consistent with congressional intent. First, the legislative history of the Dodd-Frank Act describes "hybrid" mortgages as mortgages with a "blend" of fixed-rate and adjustable-rate characteristics—generally loans with an initial fixed period and adjustment periods, such as "2/23s and 3/27s." [61] The legislative history also indicates that Congress was concerned about borrowers being trapped in mortgages likely to result in payments that would suddenly become significantly higher—often referred to as "payment shock"—because their home values had dropped, thereby "making refinancing difficult." [62]

The Board believes that Congress's overriding concern about consumers being at risk due to payment shock supports an interpretation of the term "hybrid loan" to encompass both loans that are "hybrid" in that they start with a fixed interest rate and convert to a variable rate, but also loans that are "hybrid" in that borrowers can make payments that do not pay down principal for a period of time that then convert to higher payments covering all or a portion of principal. By defining "non-standard mortgage" in this way, the proposal is intended to increase refinancing options for a wide range of at-risk consumers while remaining true to the statutory language and legislative intent.

The proposed definition of "non-standard mortgage" does not include adjustable-rate mortgages whose rate is fixed for an initial period of less than one year. In those instances, a consumer arguably does not face "payment shock" because the consumer has paid the fixed rate for such a short period of time. Another concern is that allowing streamlined refinancings under this provision where the interest rate is fixed for less than one year could result in "loan flipping." A creditor, for example, could make a covered transaction and then only a few months later refinance that loan under § 226.43(d) to take advantage of the exemption from certain ability-to-repay requirements while still profiting from the refinancing fees.

The Board recognizes that under this definition, a consumer could refinance out of a relatively stable product, such as an adjustable-rate mortgage with a fixed interest rate for a period of 10 years, which then adjusts to a variable rate for the remaining loan term (a "10/1 ARM"). Whether this is the type of product that the special refinancing provisions were meant to accommodate is unclear. The Board solicits comment on whether adjustable-rate mortgages with an initial fixed rate should be considered "non-standard mortgages" regardless of how long the initial fixed rate applies, or if the proposed initial fixed-rate period of at least one year should otherwise be revised.

The proposed definition of "non-standard mortgage" also does not include balloon mortgages. As discussed above, the Board understands Congress's intent to be to cover "hybrid" loans, meaning loans on which the monthly payment will jump because new monthly payment terms take effect, making the loan unaffordable for the remaining loan term. Balloon mortgages are not clearly "hybrid" in this sense. The monthly payments on a balloon mortgage do not necessarily increase or change from the time of consummation; rather, the entire outstanding principal balance becomes due on a particular, predetermined date. Consumers of balloon mortgages typically expect that the entire loan balance will be due at once at a certain point in time and are generally aware well in advance that they will need to repay the loan or refinance.

However, the Board recognizes that consumers of balloon mortgages may be at risk of being unable to pay the outstanding principal balance when due and may need refinancing assistance. Thus the Board solicits comment on whether to use its legal authority to include balloon mortgages in the definition of "non-standard mortgage" for purposes of the special refinancing provisions of TILA Section 129C(a)(6)(E). The Board also requests comment generally on the

[58] "The term 'adjustable-rate mortgage' means a transaction secured by real property or a dwelling for which the annual percentage rate may increase after consummation." 12 CFR 226.18(s)(7)(i).

[59] "The term 'interest-only' means that, under the terms of the legal obligation, one or more of the periodic payments may be applied solely to accrued interest and not to loan principal; an 'interest-only loan' is a loan that permits interest-only payments." 12 CFR 226.18(s)(7)(iv).

[60] "[T]he term 'negative amortization' means payment of periodic payments that will result in an increase in the principal balance under the terms of the legal obligation; the term 'negative amortization loan' means a loan that permits payments resulting in negative amortization, other than a reverse mortgage subject to section 226.33." 12 CFR 226.18(s)(7)(v).

[61] *See* U.S. House of Reps., Comm. on Fin. Services, Report on H.R. 1728, Mortgage Reform and Anti-Predatory Lending Act, No. 111–94, 51 (May 4, 2009).

[62] *Id.* at 51–52.

appropriateness of the proposed definition of "non-standard mortgage."

43(d)(2)(ii) Standard Mortgage

Proposed § 226.43(d)(2)(ii) substitutes the term "standard mortgage" for the statutory term "standard loan" and defines this term to mean a covered transaction (*see* proposed § 226.43(b)(1)) that has the following five characteristics, each of which will be discussed in more detail further below:

• *First,* the regular periodic payments may not (1) cause the principal balance to increase; (2) allow the consumer to defer repayment of principal; or (3) result in a balloon payment. In other words, to qualify as a standard mortgage, a covered transaction may not provide for negative amortization payments, payments of interest only or of only a portion of the principal required to pay off the loan amount over the loan term, or a balloon payment.

• *Second,* the total points and fees payable in connection with the transaction may not exceed three percent of the total loan amount, with exceptions for smaller loans specified in proposed § 226.43(e)(3), discussed in detail below.

• *Third,* the loan term may not exceed 40 years.

• *Fourth,* the interest rate must be fixed for the first five years after consummation.

• *Fifth,* the proceeds from the loan may be used solely to pay—(1) the outstanding principal balance on the non-standard mortgage; and (2) closing or settlement charges required to be disclosed under RESPA. In other words, the refinance must be what is commonly referred to as a "no-cash-out" refinancing, in which the consumer receives no funds from the loan proceeds for discretionary spending.

In general, the criteria for a "standard mortgage" is designed to be similar to the criteria for a "qualified mortgage" under proposed § 226.43(e)(2), which places certain limits on loan features and fees. The Board believes that this approach is appropriate to ensure that standard mortgages provide product stability and affordability for consumers.

Limitations on regular periodic payments. Under proposed § 226.43(d)(2)(ii)(A), to qualify as a standard mortgage, a covered transaction must provide for regular periodic payments that do not result in negative amortization, deferral of principal repayment, or a balloon payment. The Board believes that these limitations promote the statutory purpose of facilitating refinances that place at-risk consumers in more sustainable mortgages. These provisions are also consistent with the definition of a "qualified mortgage" under proposed § 226.43(e)(2)(i). *See* section-by-section analysis of § 226.43(e)(2), below.

Proposed comment 43(d)(2)(ii)(A)–1 explains the meaning of "regular periodic payments" that do not result in an increase of the principal balance (negative amortization) or allow the consumer to defer repayment of principal (*see* proposed comment 43(e)(2)(i)–2, discussed below). The comment explains that the requirement for "regular periodic payments" means that the contractual terms of the standard mortgage must obligate the consumer to make payments of principal and interest on a monthly or other periodic basis that will repay the loan amount over the loan term. The comment further explains that, with the exception of payments resulting from any interest rate changes after consummation in an adjustable-rate or step-rate mortgage, the periodic payments must be substantially equal. This comment notes that meaning of "substantially equal" is explained in proposed comment 43(c)(5)(i)–3 (discussed above in the section-by-section analysis of proposed § 226.43(c)(5)). In addition, the comment clarifies that "regular periodic payments" do not include a single-payment transaction and cross-references similar commentary on the meaning of "regular periodic payments" for the purposes of a "qualified mortgage" (proposed comment 43(e)(2)(i)–1).

Proposed comment 43(d)(2)(ii)(A)–1 also cross-references proposed comment 43(e)(2)(i)–2 to explain the prohibition on payments that "allow the consumer to defer repayment of principal." Proposed comment 43(e)(2)(i)-2 describes the meaning of this phrase in the context of defining the term "qualified mortgage" under proposed § 226.43(e); however, the phrase has the same meaning in the definition of "standard mortgage" under proposed § 226.43(d). Specifically, the comment states that deferral of principal repayment includes interest-only terms, under which one or more of the periodic payments may be applied solely to accrued interest and not to loan principal. Deferral of principal repayment also includes terms under which part of the periodic payment is applied to loan principal but is insufficient to pay off the loan amount over the loan term, requiring an increase in later periodic payments (or a balloon payment) to make up the principal shortfall of earlier payments. Graduated payment mortgages, for example, allow deferral of principal repayment in this manner and therefore generally may not be standard mortgages or qualified mortgages.

Three percent cap on points and fees. Proposed § 226.43(d)(2)(ii)(B) prohibits creditors from charging points and fees on the mortgage transaction of more than three percent of the total loan amount, with certain exceptions for small loans. Specifically, proposed § 226.43(d)(2)(ii)(B) cross-references the points and fees provisions under proposed § 226.43(e)(3), thereby applying the points and fees limitations for a "qualified mortgage" to a "standard mortgage." The points and fees limitation for a "qualified mortgage" is discussed in detail in the section-by-section analysis of proposed § 226.43(e)(3), below. In sum, under proposed § 226.43(e)(3)(i), the total points and fees payable in connection with a loan may not exceed—

Alternative 1:

- For a loan amount of $75,000 or more, 3 percent of the total loan amount;
- For a loan amount of greater than or equal to $60,000 but less than $75,000, 3.5 percent of the total loan amount;
- For a loan amount of greater than or equal to $40,000 but less than $60,000, 4 percent of the total loan amount;
- For a loan amount of greater than or equal to $ 20,000 but less than $40,000, 4.5 percent of the total loan amount; and
- For a loan amount of less than $20,000, 5 percent of the total loan amount.

Alternative 2:

- For a loan amount of $75,000 or more, 3 percent of the total loan amount;
- For a loan amount of greater than or equal to $20,000 but less than $75,000, a percent of the total loan amount not to exceed the amount produced by the following formula—
  - ○ Total loan amount − $20,000 = $Z
  - ○ $Z × .0036 basis points = Y basis points
  - ○ 500 basis points − Y basis points = X basis points
  - ○ X basis points × .01 = *Allowable points and fees as a percentage of the total loan amount.*
- For a loan amount of less than $20,000, 5 percent of the total loan amount.

For a detailed discussion of the alternative points and fees thresholds for qualified mortgages, see the section-by-section analysis of proposed § 226.43(e)(3), below.

In the Board's view, the proposed limitation on the points and fees that may be charged on a "standard mortgage" is important for at least three reasons. First, the limitation prevents creditors from undermining the purpose of the provision—placing at-risk consumers into more affordable loans—by charging excessive points and fees for the refinance. Second, the points and fees cap helps ensure that consumers attain a net benefit in refinancing their non-standard mortgage. The higher a consumer's upfront costs to refinance a home mortgage, the longer it will take for the consumer to recoup those costs through lower payments on the new mortgage. By limiting the amount of points and fees that can be charged in a refinance covered by § 226.43(d), the proposal reduces the amount of time it will take for the consumer to recoup his transaction costs, thus increasing the likelihood that the consumer will hold the loan long enough to in fact recoup those costs. Third, this provision is consistent with the exemption from income verification requirements for streamlined refinances under Federal government programs. *See* TILA Section 129C(a)(5). The Board is not aware of any reason why points and fees should be capped for government streamlined refinances but not for private streamlined refinances.

The Board requests comment on the proposal to apply the same limit on the points and fees that may be charged for a "qualified mortgage" under § 226.43(e) to the points and fees that may be charged on a "standard mortgage" under § 226.43(d).

Loan term of no more than 40 years. Proposed § 226.43(d)(2)(ii)(C) provides that, to qualify as a standard mortgage under proposed § 226.43(d), a covered transaction may not have a loan term of more than 40 years. The Board believes that allowing a loan term of up to 40 years is consistent with the statutory goal of promoting refinances for borrowers in potential crisis, as well as with the statutory language that requires the monthly payment for the standard mortgage to be lower than the payment for the non-standard mortgage. The proposal is intended to ensure that creditors and consumers have sufficient options to refinance a 30-year loan, for example, which is unaffordable for the consumer in the near term, into a loan with lower, more affordable payments over a longer term. This flexibility may be especially important in higher cost areas where loan amounts on average exceed loan amounts in other areas. At the same time, the Board recognizes that loans of longer terms cost more over time for the consumer.

During outreach, the Board heard concerns from consumer advocates that allowing a loan term of 40 years on any mortgage is detrimental to consumers and the market as a whole. Consumer advocates argued that 40-year loans are expensive and do not save consumers sufficient money on the monthly payment to offset this expense. Among other information, consumer advocates provided an example of a $300,000 loan at an 8 percent fixed interest rate. The difference between the 20 and 30 year payment is $308.03 a month ($2,509.32 reduced to $2,201.29). The difference between the 30- and 40-year loan is $115.36 a month. Consumer advocates question the advantages of a monthly payment reduction of $115.36 per month when the loan costs an additional $208,783 over the 40 years more than the 30-year loan.

A more appropriate comparison may be the total interest paid for the two types of loans during an equal, shorter period rather than for the life of each loan. A shorter period is relevant because most loans are prepaid well before the stated end of the term. For instance, during the first year, the total interest paid on the 30-year loan would be $23,909, compared to $23,961 for the 40-year loan. Over the first five years, total interest paid on the 30-year loan would be $117,287, compared to $118,842 on the 40-year loan, which is a difference of $1,555 more for the 40-year loan. Over the first 10 years, total interest paid on the 30-year loan would be $227,329, compared to $234,591 on the 40-year loan, which is a difference of $7,262 more for the 40-year loan.

While recognizing that a 40-year mortgage is more expensive than a 30-year mortgage over the long term, the Board is reluctant to foreclose options for consumers for whom the lower payment of a 40-year loan might make the difference between defaulting and not defaulting. The Board also notes that prevalent streamlined refinance programs permit loan terms of up to 40 years and is concerned about disrupting the current mortgage market at a vulnerable time.[63] The Board requests comment on the proposal to allow a standard mortgage to have a loan term of up to 40 years.

Interest rate is fixed for the first five years. Proposed § 226.43(d)(2)(ii)(D) requires that a standard mortgage have a fixed interest rate for the first five years (60 months) after consummation. Proposed comment 43(d)(2)(ii)(D)–1 illustrates this rule for an adjustable-rate mortgage with an initial fixed interest rate for the first five years after consummation. In the example provided, the adjustable-rate mortgage consummates on August 15, 2011, and the first monthly payment is due on October 1, 2011. The first five years after consummation occurs on August 15, 2016. The first interest rate adjustment occurs on the due date of the 60th monthly payment, which is September 1, 2016. As explained in the comment, this loan meets the requirement that the rate be fixed for the first five years after consummation because the interest rate is fixed until September 1, 2016—more than five years after consummation. This comment also cross-references proposed comment 43(e)(2)(iv)–3.iii for guidance regarding step-rate mortgages. Step-rate mortgages may have a "fixed" interest rate for five years that is not the same rate for the entire five-year period.

The Board proposes a minimum five-year fixed-rate period for standard mortgages for several reasons. First, requiring a fixed rate for five years is consistent with the statutory requirement for a qualified mortgage, which requires the creditor to underwrite the mortgage based on the maximum interest rate that may apply during the first five years after consummation. See TILA Section 129C(b)(2)(A)(v); *see also* proposed § 226.43(e)(2)(iv)(A). The Board understands that Congress intended both qualified mortgages and standard mortgages to be stable loan products, and therefore believes that the required five-year fixed-rate period for qualified mortgages is an appropriate benchmark for standard mortgages as well. As a matter of policy, the Board believes that the safeguard of a fixed rate for five years after consummation is necessary to ensure that consumers refinance into products that are stable for a substantial period of time. In the Board's view, a fixed payment for five years after consummation is a significant improvement in the circumstances of a consumer who may have defaulted absent the refinance. In effect, the proposal permits so-called "5/1 ARMs," where the interest rate is fixed for the first five years, after which time the rate becomes variable. In this regard, the proposal is intended to be generally consistent with existing streamlined refinance programs.[64] The Board's understanding based on outreach is that 5/1 ARMs in existing streamlined refinance programs have performed well.

[63] *See, e.g.,* Fannie Mae, "Home Affordable Refinance—New Refinance Options for Existing Fannie Mae Loans," Announcement 09–04, p. 8 (Mar. 4, 2009) (permitting "[f]ully-amortizing fixed-rate mortgage loans with a term up to 40 years").

[64] *See, e.g., id.* (permitting "[f]ully-amortizing ARM loans with an initial fixed period of five years or greater with a term up to 40 years").

Consumer advocates have expressed the view that a longer fixed-rate period for standard mortgages is necessary, preferably at least seven years, arguing that consumers may hold their loans longer than five years and be faced with payment shock sooner than they can afford. The Board requests comment on the proposal to require that a standard mortgage under proposed § 226.43(d) have an interest rate that is fixed for at least the first five years after consummation, including on whether the rate should be required to be fixed for a shorter or longer period and data to support any alternative time period.

In addition, the Board requests comment on whether a balloon mortgage of at least five years should be considered a "standard mortgage" under the streamlined refinancing provisions of § 226.43(d). Arguably, a balloon mortgage with a fixed, monthly payment for five years would benefit a consumer who otherwise would have defaulted. Also, a five-year balloon mortgage may not be appreciably less risky for the consumer than a "5/1 ARM," which is permitted under the proposal, depending on the terms of the rate adjustment scheduled to occur in year five.

Loan proceeds used for limited purposes. Proposed § 226.43(d)(2)(ii)(E) restricts the use of the proceeds of a standard mortgage to two purposes:

- To pay off the outstanding principal balance on the non-standard mortgage; and
- To pay closing or settlement charges required to be disclosed under the Real Estate Settlement Procedures Act, 12 U.S.C. 2601 *et seq.,* which includes amounts required to be deposited in an escrow account at or before consummation.

Proposed comment 43(d)(2)(ii)(E)–1 clarifies that if the proceeds of a covered transaction are used for other purposes, such as to pay off other liens or to provide additional cash to the consumer for discretionary spending, the transaction does not meet the definition of a "standard mortgage."

This proposal is intended to ensure that the consumer does not incur additional home mortgage debt as part of a refinance designed to prevent the consumer from defaulting on an existing home mortgage. The Board believes that permitting the consumer to lose additional equity in his or her home under TILA's special refinancing provisions would undermine the financial stability of the consumer, thus contravening the purposes of the statute. The Board requests comment, however, on whether some *de minimis* amount of cash to the consumer should be permitted, either because this allowance would be operationally necessary to cover transaction costs or for other reasons, such as to reimburse a consumer for closing costs that were over-estimated but financed.

43(d)(2)(iii) Refinancing

Proposed § 226.43(d)(2)(iii) defines the term "refinancing" to have the same meaning as in § 226.20(a). Section 226.20(a) defines the term "refinancing" generally to mean a transaction in which an existing obligation is "satisfied and replaced by a new obligation undertaken by the same consumer." Official staff commentary explains that "[w]hether a refinancing has occurred is determined by reference to whether the original obligation has been satisfied or extinguished and replaced by a new obligation, based on the parties' contract and applicable law." *See* comment 20(a)–1. However, the following, among other transaction events, are not considered "refinancings": (1) A renewal of a payment obligation with no change in the original terms; and (2) a reduction in the annual percentage rate with a corresponding change in the payment schedule. *See* § 226.20(a)(1) and (a)(2), and comment 20(a)–2.

In the Board's 2010 Mortgage Proposal, the Board proposed to revise the meaning of "refinancing" in § 226.20 to include a broader range of transactions for which creditors would be required to give consumers new TILA disclosures.[65] The Board requests comment on whether the meaning of "refinancing" in § 226.43(d) should be expanded to include a broader range of transactions, similar to those covered under the proposed revisions to § 226.20, or otherwise should be defined differently or explained more fully than proposed.

43(d)(3) Exemption From Certain Repayment Ability Requirements

Under specific conditions, proposed § 226.43(d)(3) exempts a creditor in a refinancing from two of the requirements under proposed § 226.43(c) for determining a consumer's ability to repay a home mortgage. First, the creditor is not required to comply with the income and asset verification requirements of proposed § 226.43(c)(2)(i) and (c)(4). Second, the creditor is not required to comply with the payment calculation requirements of proposed § 226.43(c)(2)(iii) and (c)(5); the creditor may instead use payment calculations prescribed in proposed § 226.43(d)(5)(ii), discussed in more detail in the section-by-section analysis of that provision.

For these exemptions to apply, all of the conditions in proposed § 226.43(d)(1)(i)–(v) described above must be met. *See* proposed § 226.43(d)(3)(i). In addition, the creditor must consider whether the standard mortgage will prevent a likely default by the consumer on the non-standard mortgage when the non-standard mortgage is recast. *See* proposed § 226.43(d)(3)(ii). This proposed provision implements TILA Section 129C(a)(6)(E)(ii), which permits a creditor to "consider if the extension of new credit would prevent a likely default should the original mortgage reset and give such concerns a higher priority as an acceptable underwriting practice." 15 U.S.C. 1639c(a)(6)(E)(ii). As clarified in proposed comment 43(d)(3)(i)–1, the Board believes that this statutory provision requires a creditor consider whether:

- the consumer is likely to default on the existing mortgage once new, higher payments are required; and
- the new mortgage will prevent the consumer's default.

Likely default. Proposed comment 43(d)(3)(i)–2 clarifies that, in considering whether the consumer's default on the non-standard mortgage is "likely," the creditor may look to widely accepted governmental and non-governmental standards for analyzing a consumer's likelihood of default. The Board does not intend to constrain servicers and other relevant parties from using other methods to determine a consumer's likelihood of default, including those tailored specifically to that servicer. Outreach participants informed the Board that servicers and others use a variety of methods for determining a consumer's likelihood of default, some of which are based on the particular servicer's historical experience with the loans it has serviced.

The Board has also considered the meaning of "imminent default" in HAMP, which, as noted, is a government program designed to assist consumers facing "imminent default" or who are in default or foreclosure. The Board's understanding, based on research and discussions with outreach participants, is that the requirements for determining what constitutes "imminent default" were not precisely defined in the HAMP rules due to the legitimate differences in servicer assessments of a consumer's likelihood of default. In addition, a servicer may use more than one method. For example, Freddie Mac representatives informed the Board that

[65] 75 FR 58539, 58594–58604, 58697–58699, 58761–58764, Sept. 24, 2010.

its tool for calculating "imminent default"—the Imminent Default Indicator or IDI—is one factor among several that Freddie Mac Seller/Servicers review in determining a consumer's likelihood of default and that these additional factors may vary depending on the type of loan and other characteristics of a particular transaction or borrower.

The Board heard from consumer advocates that "imminent default," as it has been interpreted by some to date, may be a standard that is too high for the refinancing provisions in TILA Section 129C(a)(6)(E) and could prevent many consumers from obtaining needed streamlined refinances. The proposal therefore uses the exact statutory wording—"likely default"—in implementing the provision permitting a creditor to prioritize prevention of default in underwriting a refinancing. *See* TILA Section 129C(a)(6)(E)(ii); 15 U.S.C. 1639c(a)(6)(E)(ii). In this way, the proposal is intended to distinguish the required standard for a consumer's potential default under TILA's new refinancing provisions from any particular meaning that may have been ascribed to the term "imminent default" in connection with HAMP.

The Board solicits comment on the proposal to use the term "likely default" in implementing TILA Section 129C(a)(6)(E)(ii) and on whether additional guidance is needed on how to meet the requirement that a creditor must reasonably and in good faith determine that a standard mortgage will prevent a likely default should the non-standard mortgage be recast.

Payment calculation for repayment ability determination. Proposed comment 43(d)(3)(ii)–1 explains that, if the conditions in § 226.43(d)(1) are met (discussed above), the creditor may satisfy the payment calculation requirements for determining a consumer's ability to repay the new loan by applying the calculation prescribed under § 226.43(d)(5)(ii), rather than the calculation prescribed under § 226.43(c)(2)(iii) and (c)(5). Specifically, as discussed in more detail under proposed § 226.43(d)(5)(ii) below, the creditor must calculate the standard mortgage payment based on the rate at consummation of the standard mortgage. This is the rate that will apply for the first five years after consummation; to qualify as a "standard mortgage," a mortgage must have an interest rate that is fixed for at least the first five years after consummation of the loan (*see* proposed § 226.43(d)(2)(ii)(D), discussed below). The comment explains that, as a result, if the standard mortgage is a "5/1 ARM" with a fixed rate for the first five years of payments (60 payments) followed by a variable rate, the creditor would not be required to determine the consumer's ability to repay the loan based on a payment that would result once the variable rate applies. If the loan consummates on August 15, 2011, and the first monthly payment is due on October 1, 2011, five years after consummation occurs on August 15, 2016, and the first interest rate adjustment occurs on the due date of the 60th monthly payment, which is September 1, 2016. Thus, under proposed § 226.43(d)(3)(ii), to calculate the payment required for the ability to repay rule under proposed § 226.43(c)(2)(iii), the creditor should use the payment based on the interest rate that is fixed for the first five years after consummation (from August 15, 2011, until August 15, 2016) and is not required to account for the payment resulting after the first interest rate adjustment on September 1, 2016.

The Board proposes this exemption from the general ability to repay payment calculation requirements for three reasons. First, in the Board's view, TILA Section 129C(a)(6)(E) is clearly intended to encourage creditors to refinance loans on which consumers are likely to default due to impending "payment shock." The proposal is consistent with this policy objective because underwriting a refinance based on the payment due prior to the recast means that more consumers can qualify for loans to ensure sustained homeownership. Second, the safeguards built into the definition of a "standard mortgage," discussed under the section-by-section analysis of proposed § 226.43(d)(3)(ii), mitigate risks of not accounting for the payment due after the recast in determining a consumer's ability to repay. A standard mortgage, for example, may never have negative amortization payments, interest-only payments, or a balloon payment.

Third, the statute in general seeks to ensure that consumers obtain mortgages for which the payments are affordable for a reasonable period of time. Based on the definition of a "qualified mortgage," the Board believes that Congress considered a reasonable amount of time to be the first five years after consummation of a loan. Specifically, as discussed in more detail below in the section-by-section analysis of proposed § 226.43(e)(2)(iv), an adjustable-rate mortgage is deemed to be a qualified mortgage only if, among other factors, the underwriting is based on the maximum rate permitted under the loan during the first five years. TILA Section 129C(b)(2)(A)(v), 15 U.S.C. 1639c(b)(2)(A)(v). The Board believes that the same standard is appropriately applied to determining a consumer's ability to repay a "standard mortgage" under § 226.43(d). The statute is structured to encourage creditors to make both "qualified mortgages" and "standard mortgages," consistent with congressional findings on the importance of "ensuring that responsible, affordable mortgage credit remains available to consumers." TILA Section 129B(a)(1). In particular, the statute affords creditors of both qualified mortgages and standard mortgages additional flexibility in complying with the general ability to repay underwriting requirements of TILA Section 129C(a). *See* TILA Section 129C(a)(6)(E) (for standard mortgages) and 129C(b) (for qualified mortgages), 15 U.S.C. 1639c(a)(6)(E), (b). Accordingly, the proposal requires that standard mortgages have most of the product features and restrictions assigned by Congress to qualified mortgages to ensure product stability and affordability for consumers.

Finally, the Board believes that this aspect of the proposal will facilitate compliance by allowing creditors to use a single payment calculation for determining whether: (1) The payment on the standard mortgage is "materially lower" than the payment on the non-standard mortgage; and (2) the consumer has a reasonable ability to repay the standard mortgage.

The Board requests comment on the proposal to exempt creditors of refinances that meet the conditions under proposed § 226.43(d)(1) from the income and asset verification requirements and the payment calculation requirements of the general ability-to-repay rules in proposed § 226.43(c). The Board solicits comment on whether an exemption from other ability to repay requirements under proposed § 226.43(c), such as consideration of credit history under proposed § 226.43(c)(2)(viii), may also be appropriate.

43(d)(4) Offer of Rate Discounts and Other Favorable Terms

Proposed § 226.43(d)(4) provides that a creditor making a loan under the special refinancing provisions of § 226.43(d) may offer to the consumer the same or better rate discounts and other terms that the creditor offers to any new consumer, consistent with the creditor's documented underwriting practices and to the extent not prohibited by applicable state or Federal law. This provision implements TILA Section 129C(a)(6)(E)(iii), which permits creditors of refinancings under the special conditions of TILA Section 129C(a)(6)(E) to "offer rate discounts and other favorable terms" to the borrower "that would be available to new customers with high credit ratings based on such underwriting practice." 15 U.S.C. 1639c(a)(6)(E)(iii).

The statutory provision is consistent with the congressional goal of facilitating beneficial refinancings for borrowers facing potential payment shock; the provision allows creditors to give their refinancing customers rate discounts and favorable terms they might offer to new customers with high credit ratings. The Board recognizes that the meaning of "high credit ratings" may vary by creditor and that the underwriting practices for these types of customers may vary also, including the terms that are offered. Thus the proposal does not use the term "high credit ratings" but simply states that the rate discounts and terms offered to a consumer of a § 226.43(d) loan may be the same or better than those offered to any other consumer.

The proposal does require, however, that a creditor have "documented underwriting practices" to support the creditor's offer of rate discounts and loan terms. In this way, the proposal is intended to promote transparency for examiners and consumers in understanding the basis for any special discounts or terms that the creditor offers to borrowers refinancing their home mortgages under proposed § 226.43(d). In addition, the Board recognizes that state or Federal laws may regulate the rates and terms offered to consumers depending on various consumer characteristics or other factors. For this reason, the Board proposes that the rates and terms offered to consumers under § 226.43(d) not be prohibited by other applicable state or Federal law.

The Board requests comment on the proposed interpretation of TILA Section 129C(a)(6)(E)(iii) and whether additional guidance on the meaning of proposed § 226.43(d)(4) is needed.

43(d)(5) Payment Calculations

Proposed § 226.43(d)(5) prescribes the payment calculations that must be used to determine whether the consumer's monthly payment for a standard mortgage will be "materially lower" than the monthly payment for the non-standard mortgage, as required under proposed § 226.43(d)(1)(ii), discussed above. Proposed § 226.43(d)(5) thus complements proposed § 226.43(d)(1)(ii) in implementing the statutory provision that requires a "reduction" in the monthly payment for the existing non-standard ("hybrid") mortgage when refinanced into a standard mortgage. TILA Section 129C(a)(6)(E), 15 U.S.C. 1639c(a)(6)(E). As noted above, the payment calculation for a standard mortgage required under proposed § 226.43(d)(5)(ii) is also the payment calculation that a creditor must use to calculate the monthly payment on the standard loan in determining whether the consumer is reasonably able to repay the mortgage. *See* proposed § 226.43(c)(2)(iii).

43(d)(5)(i) Non-Standard Mortgage Payment Calculation

Proposed § 226.43(d)(5)(i) requires that the monthly payment for a non-standard mortgage be based on substantially equal, monthly, fully amortizing payments of principal and interest that would result once the mortgage is "recast," as that term is defined in § 226.43(b)(11) and discussed in the section-by-section analysis of that provision. The Board believes that comparing the payment on the standard mortgage to the payment amount on which the consumer likely would have defaulted (*i.e.,* the payment resulting on the existing non-standard mortgage once the favorable terms cease and a higher payment results) promotes needed refinances consistent with congressional intent.

In the Board's view, the payment that the consumer is currently making on the existing non-standard mortgage may be an inappropriately low payment to compare to the standard mortgage payment. The existing payments may be interest-only or negatively amortizing; these temporarily lower payment amounts would be difficult for creditors to "reduce" with a refinanced loan that has a comparable term length and principal amount. Indeed, the payment on a new loan with a fixed-rate rate and fully-amortizing payment, as is required for the payment calculation of a standard mortgage under proposed § 226.43(d)(5)(ii), for example, is likely to be higher than the interest-only or negative amortization payment. As a result, few refinancings would yield a lower monthly payment, so many consumers could not receive the benefits of refinancing into a more stable loan product. In addition, streamlined refinances by GSEs and private creditors might be severely hampered, with potentially detrimental effects on the market.

Thus the proposal requires a creditor to calculate the monthly payment for a non-standard mortgage using—

- The fully indexed rate as of a reasonable period of time before or after the date on which the creditor receives the consumer's written application for the standard mortgage;
- The term of the loan remaining as of the date of the recast, assuming all scheduled payments have been made up to the recast date and the payment due on the recast date is made and credited as of that date; and
- A remaining loan amount that is—
  - For an adjustable-rate mortgage under § 226.43(d)(2)(i)(A), the outstanding principal balance as of the date the mortgage is recast, assuming all scheduled payments have been made up to the recast date and the payment due on the recast date is made and credited as of that date;
  - For an interest-only loan under § 226.43(d)(2)(i)(B), the loan amount, assuming all scheduled payments have been made up to the recast date and the payment due on the recast date is made and credited as of that date;
  - For a negative amortization loan under § 226.43(d)(2)(i)(C), the maximum loan amount.

Proposed comment 43(d)(5)(i)–1 explains that, to determine whether the monthly periodic payment for a standard mortgage is materially lower than the monthly periodic payment for the non-standard mortgage under § 226.43(d)(1)(ii), the creditor must consider the monthly payment for the non-standard mortgage that will result after the loan is "recast," as defined in § 226.43(b)(11), assuming substantially equal payments of principal and interest that amortize the remaining loan amount over the remaining term as of the date the mortgage is recast. This comment notes that guidance regarding the meaning of "substantially equal" and "recast" is provided comment 43(c)(5)(i)–4 and § 226.43(b)(11), respectively (discussed above).

Proposed comment 43(d)(5)(i)–2 explains that the term "fully indexed rate" used in § 226.43(d)(5)(i)(A) for calculating the payment for a non-standard mortgage is generally defined in § 226.43(b)(3) and associated commentary. The comment explains an important difference between the "fully indexed rate" as defined in § 226.43(b)(3), however, and the meaning of "fully indexed rate" in § 226.43(d)(5)(i). Specifically, under § 226.43(b)(3), the fully indexed rate is calculated at the time of consummation. Under § 226.43(d)(5)(i), the fully indexed rate is calculated within reasonable period of time before or after the date on which the creditor receives the consumer's written application for the standard mortgage. Comment 43(d)(5)(i)–2 clarifies that 30 days would generally be considered a "reasonable period of time."

Proposed comment 43(d)(5)(i)–3 clarifies that the term "written application" is explained in comment 19(a)(1)(i)–3. Comment 19(a)(1)(i)–3 states that creditors may rely on RESPA and Regulation X (including any interpretations issued by HUD) in deciding whether a "written application" has been received. In general, Regulation X defines "application" to mean the submission of a borrower's financial information in anticipation of a credit decision relating to a Federally related mortgage loan. *See* 24 CFR 3500.2(b). As explained in comment 19(a)(1)(i)–3, an application is received when it reaches the creditor in any of the ways applications are normally transmitted—by mail, hand delivery, or through an intermediary agent or broker. If an application reaches the creditor through an intermediary agent or broker, the application is received when it reaches the creditor, rather than when it reaches the agent or broker. This comment also cross-references comment 19(b)–3 for guidance in determining whether the transaction involves an intermediary agent or broker.

Payment calculation for an adjustable-rate mortgage with an introductory fixed rate. Proposed comments 43(d)(5)(i)–4 and –5 explain the payment calculation for an adjustable-rate mortgage with an introductory fixed rate under proposed § 226.43(d)(5)(i). Proposed comment 43(d)(5)(i)–4 clarifies that the monthly periodic payment for an adjustable-rate mortgage with an introductory fixed interest rate for a period of one or more years must be calculated based on several assumptions. First, the payment must be based on the outstanding principal balance as of the date on which the mortgage is recast, assuming all scheduled payments have been made up to that date and the last payment due under those terms is made and credited on that date. For example, assume an adjustable-rate mortgage with a 30-year loan term. The loan agreement provides that the payments for the first 24 months are based on a fixed rate, after which the interest rate will adjust annually based on a specified index and margin. The loan is recast on the due date of the 24th payment. If the 24th payment is due on September 1, 2013, the creditor must calculate the outstanding principal balance as of September 1, 2013, assuming that all 24 payments under the fixed rate terms have been made and credited on time. *See* comment 43(d)(5)(i)–4.i.

Second, the payment calculation must be based on substantially equal monthly payments of principal and interest that will fully repay the outstanding principal balance over the term of the loan remaining as of the date the loan is recast. Thus, the comment states, in the example above, the creditor must assume a loan term of 28 years (336 payments). *See* comment 43(d)(5)(i)–4.ii. Third, the payment must be based on the fully indexed rate, as defined in § 226.43(b)(3), as of the date of the written application for the standard mortgage. *See* comment 43(d)(5)(i)–4.iii.

Proposed comment 43(d)(5)(i)–5 provides an illustration of the payment calculation for an adjustable-rate mortgage with an introductory fixed rate. The example first assumes a loan in an amount of $200,000 has a 30-year loan term. The loan agreement provides for a discounted introductory interest rate of 5% that is fixed for an initial period of two years, after which the interest rate will adjust annually based on a specified index plus a margin of 3 percentage points. *See* comment 43(d)(5)(i)–5.i. Second, the example states that the non-standard mortgage is consummated on February 15, 2011, and the first monthly payment is due on April 1, 2011. The loan is recast on the due date of the 24th monthly payment, which is March 1, 2013. *See* comment 43(d)(5)(i)–5.ii. Finally, the example assumes that on March 15, 2012, the creditor receives the consumer's written application for a refinancing after the consumer has made 12 monthly on-time payments and that, on this date, the index value is 4.5%. *See* comment 43(d)(5)(i)–5.iii.

Proposed comment 43(d)(5)(i)–5 then states that, to calculate the non-standard mortgage payment that must be compared to the standard mortgage payment under § 226.43(d)(1)(ii), the creditor must use—

• The outstanding principal balance as of March 1, 2013, assuming all scheduled payments have been made up to March 1, 2013, and the last payment due under the fixed rate terms is made and credited on March 1, 2013. In this example, the outstanding principal balance is $193,948.

• The fully indexed rate of 7.5%, which is the index value of 4.5% as of March 15, 2012 (the date on which the application for a refinancing is received) plus the margin of 3%.

• The remaining loan term as of March 1, 2013, the date of the recast, which is 28 years (336 payments). *See* comment 43(d)(5)(i)–5.iv.

The comment concludes by stating that, based on the assumptions above, the monthly payment for the non-standard mortgage for purposes of determining whether the standard mortgage monthly payment is lower than the non-standard mortgage monthly payment (*see* proposed § 226.43(d)(1)(ii)) is $1,383. This is the substantially equal, monthly payment of principal and interest required to repay the outstanding principal balance at the fully-indexed rate over the remaining term. *See* comment 43(d)(5)(i)–5.v.

Payment calculation for an interest-only loan. Proposed comments 43(d)(5)(i)–6 and –7 explain the payment calculation for an interest-only loan under proposed § 226.43(d)(5)(i). Proposed comment 43(d)(5)(i)–6 clarifies that the monthly periodic payment for an interest-only loan must be calculated based on several assumptions. First, the payment must be based on the loan amount, as defined in § 226.43(b)(5) (for a loan on which only interest and no principal has been paid, the "loan amount" will be the outstanding principal balance at the time of the recast), assuming all scheduled payments are made under the terms of the legal obligation in effect before the mortgage is recast. The comment provides an example of a mortgage with a 30-year loan term for which the first 24 months of payments are interest-only. The comment then explains that, if the 24th payment is due on September 1, 2013, the creditor must calculate the outstanding principal balance as of September 1, 2013, assuming that all 24 payments under the interest-only payment terms have been made and credited. *See* comment 43(d)(5)(i)–6.i.

Second, the payment calculation must be based on substantially equal monthly payments of principal and interest that will fully repay the loan amount over the term of the loan remaining as of the date the loan is recast. Thus, in the example above, the creditor must assume a loan term of 28 years (336 payments). *See* comment 43(d)(5)(i)–6.ii. Third, the payment must be based on the fully indexed rate, as defined in § 226.43(b)(3), as of the date of the written application for the standard mortgage. *See* comment 43(d)(5)(i)–6.iii.

Proposed comment 43(d)(5)(i)–7 provides an illustration of the payment calculation for an interest-only loan. The example assumes a loan in an amount of $200,000 that has a 30-year loan term. The loan agreement provides for a fixed interest rate of 7%, and permits interest-only payments for the first two years (the first 24 payments), after which time amortizing payments of principal and interest are required. *See* comment 43(d)(5)(i)–7.i. Second, the example states that the non-standard mortgage is consummated on February 15, 2011, and the first monthly payment is due on April 1, 2011. The loan is recast on the due date of the 24th monthly payment, which is March 1, 2013. *See* comment 43(d)(5)(i)–7.ii. Finally, the example assumes that on March 15, 2012, the creditor receives the consumer's written application for a refinancing, after the consumer has made 12 monthly on-time payments. *See* comment 43(d)(5)(i)–7.iii.

Proposed comment 43(d)(5)(i)–7 then states that, to calculate the non-standard mortgage payment that must be compared to the standard mortgage payment under § 226.43(d)(1)(ii), the creditor must use—

• The loan amount, which is the outstanding principal balance as of March 1, 2013, assuming all scheduled interest-only payments have been made and credited up to that date. In this example, the loan amount is $200,000.

• An interest rate of 7%, which is the interest rate in effect at the time of consummation of this fixed-rate non-standard mortgage.

• The remaining loan term as of March 1, 2013, the date of the recast, which is 28 years (336 payments).

The comment concludes by stating that, based on the assumptions above, the monthly payment for the non-standard mortgage for purposes of determining whether the standard mortgage monthly payment is lower than the non-standard mortgage monthly payment (*see* § 226.43(d)(1)(ii)) is $1,359. This is the substantially equal, monthly payment of principal and interest required to repay the loan amount at the fully-indexed rate over the remaining term. *See* comment 43(d)(5)(i)–7.v.

Payment calculation for a negative amortization loan. Proposed comments 43(d)(5)(i)–8 and –9 explain the payment calculation for a negative amortization loan under proposed § 226.43(d)(5)(i)(C). Proposed comment 43(d)(5)(i)–8 clarifies that the monthly periodic payment for a negative amortization loan must be calculated based on several assumptions. First, the calculation must be based on the maximum loan amount, as defined in proposed § 226.43(b)(7); The comment further states that examples of how to calculate the maximum loan amount are provided in proposed comment 43(b)(7)–3 (see the section-by-section analysis of § 226.43(b)(7), above). *See* comment 43(d)(5)(i)–8.i.

Second, the payment calculation must be based on substantially equal monthly payments of principal and interest that will fully repay the maximum loan amount over the term of the loan remaining as of the date the loan is recast. For example, the comment states, if the loan term is 30 years and the loan is recast on the due date of the 60th monthly payment, the creditor must assume a loan term of 25 years (300 payments). *See* comment 43(d)(5)(i)–8.ii. Third, the payment must be based on the fully-indexed rate as of the date of the written application for the standard mortgage. *See* comment 43(d)(5)(i)–8.iii.

Proposed comment 43(d)(5)(i)–9 provides an illustration of the payment calculation for a negative amortization loan. The example assumes loan in an amount of $200,000 that has a 30-year loan term. The loan agreement provides that the consumer can make minimum monthly payments that cover only part of the interest accrued each month until the date on which the principal balance increases to the negative amortization cap of 115% of the loan amount, or for the first five years of monthly payments (60 payments), whichever occurs first. The loan is an adjustable-rate mortgage that adjusts monthly according to a specified index plus a margin of 3.5%. *See* comment 43(d)(5)(i)–9.i.

The example also states that the non-standard mortgage is consummated on February 15, 2011, and the first monthly payment is due on April 1, 2011. Further, the example assumes that, based on the calculation of the maximum loan amount required under § 226.43(b)(7) and associated commentary, the negative amortization cap of 115% is reached on July 1, 2013, the due date of the 28th monthly payment (*i.e.,* before the 60th payment is due). *See* comment 43(d)(5)(i)–9.ii. Finally, the example assumes that on March 15, 2012, the creditor receives the consumer's written application for a refinancing, after the consumer has made 12 monthly on-time payments. On this date, the index value is 4.5%. *See* comment 43(d)(5)(i)–9.iii.

Proposed comment 43(d)(5)(i)–9 then states that, to calculate the non-standard mortgage payment that must be compared to the standard mortgage payment under § 226.43(d)(1)(ii), the creditor must use—

• The maximum loan amount of $229,243 as of July 1, 2013.

• The fully indexed rate of 8%, which is the index value of 4.5% as of March 15, 2012 (the date on which the creditor receives the application for a refinancing) plus the margin of 3.5%.

• The remaining loan term as of July 1, 2013, the date of the recast, which is 27 years and 8 months (332 monthly payments).

See comment 43(d)(5)(i)–9.iv.

The comment concludes by stating that, based on the assumptions above, the monthly payment for the non-standard mortgage for purposes of determining whether the standard mortgage monthly payment is lower than the non-standard mortgage monthly payment (*see* § 226.43(d)(1)(ii)) is $1,717. This is the substantially equal, monthly payment of principal and interest required to repay the maximum loan amount at the fully-indexed rate over the remaining term. *See* comment 43(d)(5)(i)–9.v.

The Board requests comment on the proposed payment calculation for a non-standard mortgage and on the appropriateness and usefulness of the proposed payment calculation examples.

43(d)(5)(ii) Standard Mortgage Payment Calculation

Proposed § 226.43(d)(5)(ii) prescribes the required calculation for the monthly payment on a standard mortgage that must be compared to the monthly payment on a non-standard mortgage under proposed § 226.43(d)(1)(ii). The same payment calculation must also be used by creditors of refinances under proposed § 226.43(d) in determining whether the consumer has a reasonable ability to repay the standard mortgage, as required under proposed § 226.43(c)(2)(ii).

Specifically, the monthly payment for a standard mortgage must be based on substantially equal, monthly, fully amortizing payments using the maximum interest rate that may apply to the standard mortgage within the first five years after consummation. Proposed comment 43(d)(5)(ii)–1 clarifies that the meaning of "fully amortizing payment" is defined in § 226.43(b)(2), discussed above, and that guidance regarding the meaning of "substantially equal" may be found in proposed comment 43(c)(5)(i)–4, also discussed above. Proposed comment 43(d)(5)(ii)–1 also explains that, for a mortgage with a single, fixed rate for the first five years, the maximum rate that will apply during the first five years after consummation will be the rate at consummation. For a step-rate mortgage, however, which is a type of fixed-rate mortgage, the rate that must be used is the highest rate that will apply during the first five years after consummation. For example, if the rate for the first two years is 4%, the rate for the second two years is 5%, and the rate for the next two years is 6%, the rate that must be used is 6%.

Proposed comment 43(d)(5)(ii)–2 provides an illustration of the payment calculation for a standard mortgage. The example assumes a loan in an amount of $200,000 with a 30-year loan term. The loan agreement provides for a discounted interest rate of 6% that is fixed for an initial period of five years, after which time the interest rate will adjust annually based on a specified index plus a margin of 3%, subject to a 2% annual interest rate adjustment cap. The comment states that, based on the above assumptions, the creditor must determine whether the standard mortgage payment is materially lower than the non-standard mortgage payment based on a standard mortgage payment of $1,199. This is the substantially equal, monthly payment of principal and interest required to repay $200,000 over 30 years at an interest rate of 6%.

The Board requests comment on the proposed payment calculation for a standard mortgage.

43(e) Qualified Mortgages

Background

The Dodd-Frank Act. TILA Section 129C(a)(1) prohibits a creditor from making a residential mortgage loan unless the creditor makes a reasonable and good faith determination, based on verified and documented information, that the consumer has a reasonable ability to repay the loan. TILA Section 129C(a)(1)–(4) and (6)–(9) provides that the ability-to-repay determination must be based on consideration of the following underwriting factors:

• The consumer's current income, expected income the consumer is reasonably ensured of receiving, and other financial resources other than the consumer's equity in the dwelling or real property that secures repayment of the loan;

• The consumer's employment status;

• The payment of the residential mortgage loan based on a fully amortizing payment schedule and the fully-indexed rate;

• The payment of any simultaneous liens of which the creditor knows or has reason to know;

• The payment of all applicable taxes, insurance (including mortgage guarantee insurance), and assessments;

• The consumer's current obligations;

• The consumer's debt-to-income ratio or the residual income the consumer will have after paying mortgage related obligations and current debt obligations; and

• The consumer's credit history.

The ability-to-repay requirements do not contain any limits on the features, term, or costs of the loan.

TILA Section 129C(b) provides a presumption of compliance with the ability-to-repay requirements if the loan is a "qualified mortgage." Specifically, TILA Section 129C(b)(1) provides that "[a]ny creditor with respect to any residential mortgage loan, and any assignee of such loan subject to liability under this title, may presume that the loan has met the requirements of subsection (a)." With respect to underwriting requirements, TILA Section 129C(b)(2) defines a "qualified mortgage" as any residential mortgage loan—

• For which the income and financial resources relied upon to qualify the obligors on the loan are verified and documented;

• For which the underwriting of the residential mortgage loan is based on a fully amortizing payment schedule and the maximum interest rate during the first 5 years, and takes into account all applicable taxes, insurance, and assessments; and

• That complies with any guidelines or regulations established by the Board relating to ratios of total monthly debt to monthly income or alternative measures of ability to pay regular expenses after payment of total monthly debt, taking into account the income levels of the borrower and such other factors as the Board may determine relevant and consistent with the purposes of TILA Section 129C(b)(3)(B)(i).

In addition, the term "qualified mortgage" contains certain limits on the features, term, and costs of the loan. Specifically, TILA Section 129C(b) provides that a "qualified mortgage" is any residential mortgage loan—

• For which the regular periodic payments may not result in an increase of the principal balance (negative amortization) or allow the consumer to defer repayment of principal (interest-only payments);

• The terms of which do not result in a balloon payment;

• For which the loan term does not exceed 30 years; and

• For which the points and fees do not exceed 3 percent of the total loan amount.

Accordingly, a qualified mortgage cannot have an increase of the principal balance, interest-only payments, balloon payments, a term greater than 30 years, or points and fees that exceed the threshold set forth in § 226.43(e)(4). However, while the term "qualified mortgage" limits the terms of loans in ways that the general ability-to-repay requirements do not, the term "qualified mortgage" omits certain underwriting factors. Specifically, the term "qualified mortgage" does *not* include the following underwriting factors that are part of the ability-to-repay requirements:

• The consumer's employment status;

• The payment of any simultaneous liens of which the creditor knows or has reason to know;

• The consumer's current obligations; and

• The consumer's credit history.

2008 HOEPA Final Rule. Sections 226.34(a)(4) and 226.35(b)(1) prohibit a creditor from extending credit that is a high-cost loan or higher-priced mortgage loan without regard to the consumer's ability to repay. Specifically, for higher-priced mortgage loans and high-cost mortgages, the creditor must follow required procedures, such as verifying the consumer's income or assets. Section 226.34(a)(4) and comments 34(a)(4)–2 and –3. The 2008 HOEPA Final Rule further provides a presumption of compliance with the ability-to-repay requirements if the creditor follows additional optional procedures regarding underwriting the loan payment, assessing the debt-to-income ratio or residual income, and limiting the features of the loan. Section 226.34(a)(4)(iii)–(iv) and comment 34(a)(4)(iii)–1. However, the 2008 HOEPA Final Rule makes clear that even if the creditor follows the required and optional criteria, the creditor has merely obtained a *presumption* of compliance with the repayment ability requirement. Comment 34(a)(4)(iii)–1. The consumer can still rebut or overcome that presumption by showing that, despite following the required and optional procedures, the creditor nonetheless disregarded the consumer's ability to repay the loan. For example, the consumer could present evidence that although the creditor assessed the creditor's debt-to-income ratio, the debt-to-income ratio was very high with little residual income. This evidence may be sufficient to overcome the presumption of compliance and demonstrate that the creditor extended credit without regard to the consumer's ability to repay the loan.

Qualified Mortgages and the Presumption of Compliance

With regard to the ability-to-repay requirement, the Dodd-Frank Act provides special protection from liability for creditors who make "qualified mortgages." However, it is unclear whether that protection is intended to be a safe harbor or a presumption of compliance with the ability-to-repay requirement. An analysis of the statutory construction and policy implications demonstrate that there are sound reasons for adopting either interpretation. For this reason, the Board is proposing two alternative definitions of a "qualified mortgage": One that operates as a safe harbor and one that operates as a presumption of compliance.

With respect to statutory construction, on the one hand, the Dodd-Frank Act states that a creditor or assignee "may presume" that a loan has met the repayment ability requirement if the loan is a qualified mortgage. TILA Section 129C(b)(1). This suggests that originating a qualified mortgage provides a presumption of compliance, which the consumer can rebut by providing evidence that the creditor did not, in fact, make a good faith and reasonable determination of the consumer's ability to repay the loan.

On the other hand, the statutory structure suggests that the "qualified mortgage" is an alternative to the general ability-to-repay standard and thus would operate as a safe harbor. First, TILA Section 129C(b)(1) states that a creditor or assignee may presume that a loan has "met the requirements of subsection (a), if the loan is a qualified mortgage." TILA Section 129C(a) contains the ability-to-repay requirement as well as all of the underwriting criteria for the general ability-to-repay standard. Rather than stating that the presumption of compliance applies only to TILA Section 129C(a)(1) for the ability-to-repay requirement, it appears Congress intended creditors who make qualified mortgages to be presumed to comply with both the ability-to-repay requirement and the underwriting criteria for the general ability-to-repay standard. Second, TILA Section 129C(b)(2) does not define a "qualified mortgage" as requiring compliance with all of the underwriting criteria of the general ability-to-repay standard. Therefore, unlike the approach found in the 2008 HOEPA Final Rule, it appears that the criteria for a "qualified mortgage" would be an *alternative* to the general ability-to-repay standard, rather than an addition to that standard.

With respect to the policy implications, there are sound reasons for interpreting a qualified mortgage as providing either a safe harbor or a presumption of compliance. On the one hand, interpreting a "qualified mortgage" as a safe harbor would provide creditors with an incentive to make qualified mortgages. That is, in exchange for limiting loan fees and features, the creditor's regulatory burden and exposure to liability would be reduced. Consumers may benefit by being provided with mortgage loans that do not have certain risky features or high costs.

However, there are at least two drawbacks to the "safe harbor" approach. First, the definition of a "qualified mortgage" is not necessarily consistent with ensuring the consumer's ability to repay the loan. Some of the key elements in the statutory definition of a qualified mortgage, while designed to ensure that qualified mortgages do not contain risky features, do not directly address whether a qualified mortgage is affordable for a particular borrower. Although the qualified mortgage limits on loan terms and costs may, in general, tend to make loans more affordable (in part because loan terms would be more transparent to consumers thus enabling consumers to more easily determine affordability for themselves), the limits on loan terms and costs would not ensure that a given consumer could necessarily afford a particular loan. Second, the "safe harbor" approach would limit the consumer's ability to challenge a creditor's determination of repayment ability. That is, creditors could not be challenged for failing to underwrite the loan based on the consumer's employment status, simultaneous loans, current debt obligations, or credit history, or for generally not making a reasonable and good faith determination of the consumer's ability to repay the loan.

On the other hand, interpreting a "qualified mortgage" as providing a rebuttable presumption of compliance would better ensure that creditors consider a consumer's ability to repay the loan. Creditors would have to make individualized determinations that the consumer has the ability to repay the loan based on all of the underwriting factors listed in the general ability-to-repay standard. This approach would require the creditor to comply with all of the ability-to-repay standards, and preserve the consumer's ability to use these standards in a defense to foreclosure or other legal action. In addition, a consumer could assert that, despite complying with the criteria for a qualified mortgage and the ability-to-repay standard, the creditor did not make a reasonable and good faith determination of the consumer's ability to repay the loan.

The drawback of treating a "qualified mortgage" as providing a presumption of compliance is that it provides little legal certainty for the creditor, and thus little incentive to make a "qualified mortgage," which limits loan fees and features. As stated above, the underwriting requirements found in the general repayment ability rule are based on individualized determinations that will vary from consumer to consumer. As such, creditors or assignees may not be able to make bright-line judgments as to whether or not a loan complies with these underwriting requirements. In many cases sound underwriting practices require judgment about the relative weight of various risk factors (such as the tradeoff between a consumer's credit history and debt-to-income ratio). These decisions are usually based on complex statistical default models or lender judgments, which will differ across originators and over time. While the Board's proposal would allow creditors to look to widely accepted underwriting standards in complying with the general ability-to-repay standard, those standards may leave room for the exercise of discretion and judgment by creditors and loan originators which could increase potential compliance and litigation risk, thus weakening the incentive to make qualified mortgages (even with a presumption of compliance for qualified mortgages). As stated above, a violation of the ability-to-repay requirement now provides a consumer with a defense to foreclosure for an unlimited amount of time. Dodd-Frank Act Section 1413; TILA Section 130(k).

The Board's Proposal

Given the statutory ambiguity and competing concerns described above, the Board proposes two alternative definitions for a qualified mortgage. Under Alternative 1, a qualified mortgage would include only the specific requirements listed in TILA Section 129C(b)(2), and would provide creditors with a safe harbor to establish compliance with the general repayment ability requirement in proposed § 226.43(c)(1). That is, a consumer would have to show that a loan was not a qualified mortgage under § 226.43(e) (*e.g.,* that the loan permits negative amortization) in order to assert that the loan violated the repayment ability requirement under § 226.43(c). Under Alternative 2, a qualified mortgage would include the specific requirements listed in the TILA Section 129C(b)(2), as well as additional requirements taken from the proposed general ability-to-repay standard in § 226.43(c)(2)–(7). Because Alternative 2 would require compliance with the general ability-to-repay standard, it would provide a presumption of compliance with the ability-to-repay requirement. However, as discussed more fully below, a consumer would be able to rebut the presumption of compliance (even if the loan was a qualified mortgage) by demonstrating that the creditor did not adequately determine the consumer's ability to repay the loan.

43(e)(1) In General

ALTERNATIVE 1

Proposed § 226.43(e)(1) would implement TILA Section 129C(b)(1) and state that the creditor or assignee complies with § 226.43(c)(1) if the covered transaction is a qualified mortgage, as defined in § 226.43(e)(2). Proposed § 226.43(e)(2) would implement TILA Section 129C(b)(2), and state that a "qualified mortgage" is a covered transaction—

- That provides for regular periodic payments that do not—
  - Result in an increase of the principal balance (negative amortization);
  - Allow the consumer to defer repayment of principal (*i.e.,* interest-only payments); or
  - Result in a balloon payment;
- For which the loan term does not exceed 30 years;
- For which the total points and fees payable in connection with the loan do not exceed the threshold set forth in § 226.43(e)(3);
- For which the creditor underwrites the loan using the following method:
  - The creditor uses a periodic payment of principal and interest based on the maximum interest rate that may apply during the first 5 years after consummation;
  - The periodic payments of principal and interest would fully repay either the loan amount over the loan term; or the outstanding principal balance as of the date the interest rate adjusts to the maximum interest rate;
  - The creditor takes into account any mortgage-related obligations; and
- For which the creditor considers and verifies the consumer's current or reasonably expected income or assets.

Alternative 1 would construe the statutory text to provide creditors with bright-line standards as an incentive to make loans without certain risky features and high costs. The statutory definition of a "qualified mortgage" includes only items which would allow creditors and assignees to easily and efficiently verify whether or not a loan is a "qualified mortgage." By confining the qualified mortgage definition to certain loan terms, features, and costs, and by requiring only that the loan be underwritten based on certain straightforward assumptions and using verified information about the consumer's income or assets, creditors and assignees can obtain a high degree of certainty that a loan is a qualified mortgage. Moreover, by clarifying that a qualified mortgage is a safe harbor for compliance with the general repayment ability rule, Alternative 1 would provide creditors and assignees with the highest level of certainty about potential legal and compliance risks and, concomitantly, the strongest incentive to make qualified mortgages.

Accordingly, proposed comment 43(e)(1)–1-Alternative 1 would clarify that a creditor assignee complies with § 226.43(c)(1) if a covered transaction meets the conditions for a "qualified mortgage" under § 226.43(e)(2) (or § 226.43(f), if applicable). That is, a creditor or assignee need not demonstrate compliance with § 226.43(c)(2)–(7) if the terms of the loan comply with § 226.43(e)(2)(i)–(ii) (or § 226.43(f), if applicable); the loan's points and fees do not exceed the limits set forth in § 226.43(e)(2)(iii); and the creditor has complied with the underwriting criteria described in § 226.43(e)(2)(iv)–(v) (or § 226.43(f), if applicable). The consumer may show the loan is not a qualified mortgage with evidence that the terms, points and fees, or underwriting not comply with § 226.43(e)(2) (or § 226.43(f), if applicable). If a loan is not a qualified mortgage (for example because the loan provides for negative amortization), then the creditor or assignee must demonstrate that loan complies with all of the requirements in § 226.43(c) (or § 226.43(d), if applicable).

Debt-to-income ratio and residual income. While consideration of a consumer's debt-to-income ratio is required under the general ability-to-repay standard, TILA Section 129C(b)(2)(A)(vi) provides that qualified mortgages must comply with any guidelines or regulations established by the Board for the consumer's DTI ratio or residual income. For several reasons, under Alternative 1 the Board is not proposing to require creditors to consider the consumer's debt-to-income ratio or residual income to make a qualified mortgage. First, the debt-to-income ratio and residual income are based on widely accepted standards, which, although flexible, do not provide certainty that a loan is a qualified mortgage. Congress seems to have intended to provide incentives to creditors to make qualified mortgages, since they have less risky terms and features. Second, because the definition of a qualified mortgage under Alternative 1 would not require consideration of current debt obligations or simultaneous loans, it would be impossible for a creditor to calculate the debt-to-income ratio or residual income without adding those requirements as well. Third, data show that the debt-to-income ratio generally does not have significant predictive power of loan performance once the effects of credit history, loan type, and loan-to-value ratio are considered.[66] Fourth, although consideration of the mortgage debt-to-income ratio, the so-called "front-end debt-to-income ratio," might help ensure that consumers receive loans on terms that reasonably reflect their ability to repay the loans, Board outreach indicated that creditors often do not find that the "front-end debt-to-income ratio" is a strong predictor of ability to repay.

Finally, the Board is concerned that the benefit of including the debt-to-income ratio or residual income in the definition of "qualified mortgage" may not outweigh the cost to certain consumers. In some cases, consumers may not meet widely accepted debt-to-income ratio standards, but may have other compensating factors, such as sufficient residual income or other resources, to be able to reasonably to afford mortgage payments. A definition of "qualified mortgage" that required creditors to consider the consumer's debt-to-income ratio or residual income could limit the availability of credit to those consumers. While some creditors may be willing to take on the potential compliance costs associated with considering compensating factors, other creditors may choose not to extend qualified mortgages to consumers who do not meet the creditor's specific thresholds.

ALTERNATIVE 2

Under Alternative 2, a qualified mortgage would include the requirements in proposed § 226.43(e)(2)–Alternative 1, as well as additional ability-to-repay requirements. Specifically, proposed § 226.43(e)(2)(v)–Alternative 2 would require the creditor (by a cross-reference to the creditor's obligations in § 226.43(c)) to consider the following under the ability-to-repay requirements: (1) The consumer's employment status, (2) any simultaneous loans, (3) the consumer's current debt obligations, and (4) the consumer's credit history. Proposed § 226.43(e)(1)–Alternative 2 would implement TILA Section 129C(b)(1), and state that a creditor or assignee of a covered transaction is presumed to have complied with the repayment ability requirement of § 226.43(c)(1) if the covered transaction is a qualified mortgage, as defined in § 226.43(e)(2).

[66] *See* Demyanyk Yuliya & Van Hemert, Otto *Understanding the Subprime Mortgage Crisis,* The Review of Financial Studies (2009); Berkovec, James A., Canner, Glenn B., Gabriel, Stuart A., and Hannan, Timothy H., *Race, Redlining, and Residential Mortgage Loan Performance*. The Journal of Real Estate Finance and Economics (2004).

As discussed further below, the Board proposes these revisions to the definition of a "qualified mortgage" under its authority under TILA Section 129C(b)(3)B)(i). The Board believes this alternative definition would further the purpose of TILA Section 129C by requiring creditors to consider specific underwriting criteria to ensure a consumer's ability to repay a qualified mortgage. In addition, proposed § 226.43(e)(2)(v)–Alternative 2 implements TILA Section 129C(b)(2)(vi) by requiring creditors to consider the consumer's monthly debt-to-income ratio or residual income, as provided in proposed § 226.43(c)(2)(vii).

Proposed comment 43(e)(1)–1–Alternative 2 provides that a creditor or assignee is presumed to have complied with the requirement of § 226.43(c)(1) if the terms of the loan comply with § 226.43(e)(2)(i)–(ii) (or § 226.43(f), if applicable); the loan's points and fees do not exceed the limit set forth in § 226.43(e)(2)(iii); and the creditor has complied with the underwriting criteria described in § 226.43(e)(2)(iv)–(v) (or § 226.43(f), if applicable). If the loan is not a qualified mortgage (for example, because the loan provides for negative amortization), then the creditor or assignee must demonstrate that the loan complies with all of the requirements of § 226.43(c) (or § 226.43(d), if applicable). However, even if the loan is a qualified mortgage, the consumer may rebut the presumption of compliance with evidence that the loan did not comply with § 226.43(c)(1). For example, evidence of a debt-to-income ratio with no compensating factors, such as adequate residual income, could be used to rebut the presumption. The Board solicits comment on this approach.

The Board solicits comments on the two proposed alternative definitions of a qualified mortgage, or other alternative definitions. The Board specifically solicits comment, including supporting data, on what criteria should be included in the definition of a qualified mortgage to ensure that the definition provides an incentive to creditors to make qualified mortgages, while also ensuring that consumers have the ability to repay qualified mortgages.

43(e)(2) Qualified Mortgage Defined

Proposed § 226.43(e)(2) implements TILA Section 129C(b)(2) and states that a "qualified mortgage" is a covered transaction—

- That provides for regular periodic payments that do not:
  - Result in an increase of the principal balance (*i.e.,* negative amortization);
  - Allow the consumer to defer repayment of principal (*i.e.,* interest-only payments); or
  - Result in a balloon payment;
- For which the loan term does not exceed 30 years;
- For which the total points and fees payable in connection with the loan do not exceed the threshold set forth in § 226.43(e)(3);
- For which the creditor underwrites the loan using the following method:
  - The creditor uses a periodic payment of principal and interest based on the maximum interest rate that may apply during the first 5 years after consummation;
  - The periodic payments of principal and interest would fully repay either the loan amount over the loan term; or the outstanding principal balance as of the date the interest adjusts to the maximum interest rate;
  - The creditor takes into account any mortgage-related obligations; and
- For which the creditor considers and verifies the consumer's current or reasonably expected income or assets.[67]

43(e)(2)(i) Limits on Periodic Payments

TILA Section 129C(b)(2)(A)(i) states that the regular periodic payments of a qualified mortgage may not result in an increase of the principal balance or allow the consumer to defer repayment of principal (except for certain balloon-payment loans, discussed below in the section-by-section analysis for § 226.43(f)). TILA Section 129C(b)(2)(A)(ii) states that the terms of a qualified mortgage may not include a balloon payment (except for certain balloon-payment loans, discussed below in the section-by-section analysis for § 226.43(f)). The statute defines "balloon payment" as "a scheduled payment that is more than twice as large as the average of earlier scheduled payments."

Proposed § 226.43(e)(2)(i) implements TILA Sections 129C(b)(2)(A)(i) and (ii). First, the proposed provision requires that a qualified mortgage provide for regular periodic payments. Proposed comment 43(e)(2)(i)–1 clarifies that, for this reason, a single-payment transaction, where no payment of principal or interest is required until maturity, may not be a qualified mortgage. Second, proposed § 226.43(e)(2)(i) provides that the regular periodic payments may not (1) result in an increase of the principal balance; (2) allow the consumer to defer repayment of principal, except as provided in § 226.43(f), discussed below; or (3) result in a balloon payment, as defined in § 226.18(s)(5)(i), except as provided in § 226.43(f), discussed below.

Proposed comment 43(e)(2)(i)–1 explains that, as a consequence of the foregoing prerequisites, a qualified mortgage must require the consumer to make payments of principal and interest, on a monthly or other periodic basis, that will fully repay the loan amount over the loan term. These periodic payments must be substantially equal except for the effect that any interest rate change after consummation has on the payment amount in the case of an adjustable-rate or step-rate mortgage. The proposed comment also notes that, because § 226.43(e)(2)(i) requires that a qualified mortgage provide for regular, periodic payments, a single-payment transaction may not be a qualified mortgage. This result would prevent potential evasion, as a creditor otherwise could structure a transaction with a single payment due at maturity (economically, a near equivalent to a balloon-payment loan) that technically would not be a balloon payment as defined in § 226.18(s)(5)(i) because it is not more than two times a regular periodic payment.

Proposed comment 43(e)(2)(i)–2 provides additional guidance on the requirement in proposed § 226.43(e)(2)(i)(B) that a qualified mortgage may not allow the consumer to defer repayment of principal. The comment clarifies that, in addition to interest-only terms, deferred principal repayment also occurs if the payment is applied to both accrued interest and principal but the consumer makes periodic payments that are less than the amount that would be required under a payment schedule that has substantially equal payments that fully repay the loan amount over the loan term. Graduated payment mortgages, for example, allow deferral of principal repayment in this manner and therefore may not be qualified mortgages.

As noted above, the statute defines "balloon payment" as "a scheduled payment that is more than twice as large as the average of earlier scheduled payments." Proposed § 226.43(e)(2)(i)(C) cross-references Regulation Z's existing definition of "balloon payment" in § 226.18(s)(5)(i). That definition provides that a balloon payment is "a payment that is more than two times a regular periodic payment." This definition is substantially similar to the statutory one, except that it uses as its benchmark any regular periodic payment rather than the average of earlier scheduled payments.

[67] As discussed below in this section-by-section analysis, in certain limited situations, a creditor may comply with the requirements of § 226.43(f) instead of certain requirements § 226.43(e).

The Board believes that, because a qualified mortgage generally must provide for substantially equal, fully amortizing payments of principal and interest, a payment that is greater than twice any one of a loan's regular periodic payments also generally will be greater than twice the average of its earlier scheduled payments. Thus, the Board believes that the difference in wording between the statutory definition and the existing regulatory definition, as a practical matter, does not yield a significant difference in what constitutes a "balloon payment" in the qualified mortgage context. Accordingly, in the interest of facilitating compliance by affording creditors a single definition within Regulation Z, the Board is proposing to cross-reference § 226.18(s)(5)(i)'s definition of "balloon payment" in § 226.43(e)(2)(i)(C). The Board proposes this adjustment to the statutory definition pursuant to its authority under TILA Section 105(a) to make such adjustments for all or any class of transactions as in the judgment of the Board are necessary or proper to facilitate compliance with TILA. 15 U.S.C. 1604(a). The class of transactions for which this adjustment is proposed is all covered transactions, *i.e.,* closed-end consumer credit transactions that are secured by a dwelling. The Board solicits comment on the appropriateness of this proposed adjustment to the definition of "balloon payment." This approach is further supported by the Board's authority under TILA Section 129B(e) to condition terms, acts or practices relating to residential mortgage loans that the Board finds necessary or proper to facilitate compliance. 15 U.S.C. 1639b(e).

The Board recognizes that some balloon-payment loans are renewable at maturity. Such loans might appropriately be eligible to be qualified mortgages, provided the terms for renewal eliminate the risk of the consumer facing a large, unaffordable payment obligation, which underlies the rationale for generally excluding balloon-payment loans from the definition of qualified mortgages. If the consumer is protected by the terms of the transaction from that risk, such a transaction might appropriately be treated as though it effectively is not a balloon-payment loan even if it is technically structured as one.

Accordingly, the Board solicits comment on whether it should include an exception providing that, notwithstanding § 226.43(e)(2)(i)(C), a qualified mortgage may provide for a balloon payment if the creditor is unconditionally obligated to renew the loan at the consumer's option (or is obligated to renew subject to conditions within the consumer's control). The Board also seeks comment on how such an exception should be structured to ensure that the large-payment risk ordinarily accompanying a balloon-payment loan is fully eliminated by the renewal terms. For example, the exception might provide that the balloon-payment loan must be renewable on terms that either (1) do not include a balloon payment; or (2) obligate the creditor unconditionally (or subject to conditions within the consumer's control) to renew the loan again upon expiration of each renewed loan term, and the loan term resulting from such multiple renewals is at least equal to the amortization period of the loan. Finally, the Board recognizes that such an exception could enable a creditor to circumvent the prohibition on qualified mortgages providing for balloon payments by structuring a balloon-payment loan as unconditionally renewable but with new terms that effectively render the loan as renewed unaffordable for the consumer, such as a substantially greater interest rate. The Board seeks comment on how such an exception might be structured to avoid the potential for such circumvention.

43(e)(2)(ii) Loan Term

TILA Section 129C(b)(2)(A)(viii) requires that a qualified mortgage must not provide for a loan term that exceeds 30 years, "except as such term may be extended under paragraph (3), such as in high-cost areas." Under TILA Section 129C(b)(3)(B)(i), the Board is authorized "to revise, add to, or subtract from the criteria that define a qualified mortgage upon a finding that such regulations are necessary or proper to ensure that responsible, affordable mortgage credit remains available to consumers in a manner consistent with the purposes of this section, necessary and appropriate to effectuate the purposes of this section and section 129B, to prevent circumvention or evasion thereof, or to facilitate compliance with such sections."

Proposed § 226.43(e)(2)(ii) implements the 30-year maximum loan term without any exception. Based on information available through outreach and data analysis, the Board believes that mortgage loans with terms greater than 30 years are rare and, when made, generally are for the convenience of customers who could qualify for a loan with a 30-year term but prefer to spread out their payments further. Therefore, the Board believes such an exception generally is not necessary "to ensure that responsible, affordable mortgage credit remains available to consumers" in "high-cost areas." This belief is in contrast with the Board's proposal to implement TILA Section 129C(a)(6)(E) concerning refinancing of an existing hybrid loan into a standard loan, in proposed § 226.43(d). As discussed in more detail above, proposed § 226.43(d)(2) provides an exemption from certain repayment ability requirements when a creditor refinances a non-standard mortgage into a standard mortgage. Proposed § 226.43(d)(4)(ii)(C) permits a standard mortgage to have a loan term of up to 40 years. The Board believes that a 40-year loan term may be necessary to ensure affordable mortgage credit remains available for a refinancing that is being extended specifically to prevent a likely default, as provided in proposed § 226.43(d)(2)(i)(B).

The Board solicits comment on whether there are any "high-cost areas" in which loan terms in excess of 30 years are necessary to ensure that responsible, affordable credit is available and, if so, how they should be identified for purposes of such an exception. The Board also seeks comment on whether any other exceptions would be appropriate, consistent with the Board's authority in TILA Section 129C(b)(3)(B)(i).

43(e)(2)(iii) Points and Fees

TILA Section 129C(b)(2)(A)(vii) defines a "qualified mortgage" as a loan for which, among other things, the total points and fees payable in connection with the loan do not exceed three percent of the total loan amount. TILA Section 129C(b)(2)(D) requires the Board to prescribe rules adjusting this threshold to "permit lenders that extend smaller loans to meet the requirements of the presumption of compliance." The statute further requires the Board, in prescribing such rules, to "consider the potential impact of such rules on rural areas and other areas where home values are lower." Proposed § 226.43(e)(2)(iii) implements these provisions by providing that a qualified mortgage is a loan for which the total points and fees payable in connection with the loan do not exceed the amounts specified under § 226.43(e)(3). As discussed in detail in the section-by-section analysis for § 226.43(e)(3), the Board proposes two alternatives for calculating the allowable points and fees for a qualified mortgage. Proposed § 226.43(b)(9) defines "points and fees" to have the same meaning as in § 226.32(b)(1), addressed above.

43(e)(2)(iv) Underwriting of the Loan

TILA Sections 129C(b)(2)(A)(iv) and (v) provide as a condition to meeting the definition of a qualified mortgage, in addition to other criteria, that the underwriting process for a fixed-rate or adjustable-rate loan be based on "a payment schedule that fully amortizes the loan over the loan term and takes into account all applicable taxes, insurance, and assessments." The statute further states that for an adjustable-rate loan, the underwriting must be based on "the maximum rate permitted under the loan during the first 5 years." *See* TILA Section 129C(b)(2)(A)(v). The statute does not define the terms "fixed rate," adjustable rate," or "loan term," and provides no additional set of assumptions regarding how to calculate the payment obligation.

These statutory requirements differ from the payment calculation requirements set forth under § 226.34(a)(4)(iii) of the Board's 2008 HOEPA Final Rule. Section 226.34(a)(4)(iii) states that a presumption of compliance exists where the creditor underwrites the loan using the largest payment of principal and interest scheduled in the first seven years following consummation. The existing presumption of compliance under § 226.34(a)(4)(iii) is available for all loan types, except for loans with negative amortization or balloon loans with a term less than seven years. In contrast, TILA Section 129C(b)(2)(A) provides a five-year time horizon for purposes of underwriting the loan to the maximum interest rate, and does not extend the scope of qualified mortgages to any loan that contains certain risky features or a loan term exceeding 30 years. For example, loans that permit deferral of principal or that have a term greater than 30 years would not meet the definition of a qualified mortgage. *See* proposed § 226.43(e)(2)(i) and (ii). In addition, loans with a balloon feature would not meet the definition of a qualified mortgage regardless of term length, unless made by a creditor that satisfies the conditions set forth under the proposed exception. *See* proposed § 226.43(f)(1).

The Board's Proposal

The Board proposes § 226.43(e)(2)(iv) to implement the underwriting requirements of TILA Sections 129C(b)(2)(A)(iv) and (v), as enacted by Section 1412 of the Dodd-Frank Act, for purposes of determining whether a loan meets the definition of a qualified mortgage. Under the proposal, creditors would be required to underwrite the consumer for a loan that is a fixed-, adjustable-, or step-rate mortgage using a periodic payment of principal and interest based on the maximum interest rate permitted during the first five years after consummation. The terms "adjustable-rate mortgage," step-rate mortgage," and "fixed-rate mortgage" have the meaning as in current § 226.18(s)(7)(i)–(iii), respectively.

Specifically, proposed § 226.43(e)(2)(iv) provides that meeting the definition of a qualified mortgage is contingent, in part, on creditors underwriting the loan in the following manner:

(1) First, proposed § 226.43(e)(2)(iv) requires that the creditor take into account any mortgage-related obligations when underwriting the consumer's loan.

(2) Second, proposed § 226.43(e)(2)(iv)(A) requires creditors to use the maximum interest rate that may apply during the first five years after consummation;

(3) Third, proposed § 226.43(e)(2)(iv)(B) requires that the periodic payments of principal and interest repay either 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 can occur during the first five years after consummation, or the loan amount over the loan term; and

These three underwriting conditions under proposed § 226.43(e)(2)(iv) are discussed below.

43(e)(2)(iv) Mortgage-Related Obligations

Proposed § 226.43(e)(2)(iv) implements TILA Section 129C(b)(2)(A)(iv) and (v), in part, and provides that the creditor underwrite the loan taking into account any mortgage-related obligations. As discussed in proposed § 226.43(b)(8), the Board proposes to use the term "mortgage-related obligations" to refer to "all applicable taxes, insurance (including mortgage guarantee insurance), and assessments." Proposed § 226.43(b)(8) would define the term "mortgage-related obligations" to mean property taxes; mortgage-related insurance premiums required by the creditor as set forth in proposed § 226.45(b)(1); homeowner association, condominium, and cooperative fees; ground rent or leasehold payments; and special assessments. Unlike the requirement under proposed § 226.43(c)(5)(v), however, creditors would not need to verify and document mortgage-related obligations for purposes of satisfying this underwriting condition. Proposed comment 43(e)(2)(iv)–6 provides cross-references to proposed § 226.43(b)(8) and associated commentary to facilitate compliance.

43(e)(2)(iv)(A) Maximum Interest Rate During First Five Years

Proposed § 226.43(e)(2)(iv)(A) implements TILA Sections 129C(b)(2)(A)(iv) and (v), in part, and provides as a condition to meeting the definition of a qualified mortgage that the creditor underwrite the loan using the maximum interest rate that may apply during the first five years after consummation. The statute does not define the term "maximum rate." In addition, the statute does not clarify whether the phrase "the maximum rate permitted under the loan during the first 5 years" means the creditor should use the maximum interest rate that occurs during the first five years of the loan beginning with the first periodic payment due under the loan, or during the first five years after consummation of the loan. The distinction between these two approaches is that the former would capture the rate reset for a 5/1 hybrid ARM that occurs on the due date of the 60th monthly payment, and the latter would not.

Maximum interest rate. The Board interprets the phrase "maximum rate permitted" as requiring creditors to underwrite the loan based on the maximum interest rate that could occur under the terms of the loan during the first five years after consummation, assuming a rising index value. *See* TILA Section 129C(b)(2)(A)(v). The plain meaning of "maximum" is to the greatest possible degree or amount. For this reason, the Board believes it is reasonable to interpret the phrase as requiring the creditor to use the maximum rate possible, assuming that the index value is increasing. *See* proposed comment 43(e)(2)(iv)–1. This interpretation is consistent with current guidance contained in Regulation Z regarding disclosure of the maximum interest rate. See MDIA Interim Rule, 75 FR 58471, Sept. 24, 2010. The Board further believes this interpretation is consistent with Congressional intent to encourage creditors to make loans to consumers that are less risky and that afford the consumer a reasonable period of time to repay (*i.e.,* 5 years) on less risky terms.

First five years after consummation. For several reasons, the Board proposes to interpret the phrase "during the first 5 years" as requiring creditors to underwrite the loan based on the maximum interest rate that may apply during the first five years *after consummation.* TILA Section 129C(b)(2)(A)(v). First, a plain reading of the statutory language conveys that the "first 5 years" is the first five years of the loan once it comes into existence (*i.e.,* once it is consummated). Interpreting the phrase to mean the first five years beginning with the first periodic payment due under the loan would require an expansive reading of the statutory text.

Second, the Board believes the intent of this underwriting condition is to ensure that the consumer can afford the loan's payments for a reasonable amount of time. The Board believes that Congress intended for a reasonable amount of time to be the first five years after consummation, and therefore interprets the statutory text "maximum rate permitted during the first five years" accordingly.

Third, the Board believes this approach is consistent with prior iterations of this statutory text and the Board's 2008 HOEPA Final Rule. As noted above, the Dodd-Frank Act codifies many aspects of the repayment ability requirements contained in § 226.34(a)(4) of the Board's 2008 HOEPA Final Rule. Previous versions of this statutory text provided that creditors underwrite the loan using the maximum interest rate during the first seven years;[68] this time horizon parallels § 226.34(a)(4)(iii), which requires creditors to determine a consumers repayment ability using the largest payment in first seven years "*following consummation.*"

Fourth, the Board believes that interpreting the phrase "during the first five years" as including the rate adjustment at the end of the fifth year would be of limited benefit to consumers because creditors could easily structure their product offerings to avoid application of the rule. For example, a creditor could move a rate adjustment that typically occurs on the due date of the 60th monthly payment to due date of the first month that falls outside the specified time horizon, making any proposal to extend the time period in order to include the rate adjustment of diminished value.

Finally, the Board recognizes that the proposed timing of the five-year period differs slightly from the approach used under the 2010 MDIA Interim Final Rule, but believes this is appropriate given the different purposes of the rules. The Board recently amended the 2010 MDIA Interim Final Rule to require that creditors base their disclosures on the first five years after the first regular periodic payment due date rather than the first five years after consummation. *See* 75 FR 81836, Dec. 29, 2010. The revision clarifies that the disclosure requirements for 5/1 hybrid ARMs must include the rate adjustment that occurs on the due date of the 60th monthly payment, which typically occurs more than five years after consummation. The disclosure requirements under the 2010 MDIA Interim Final Rule, as revised, are intended to help make consumers aware of changes to their loan terms that may occur if they choose to stay in the loan beyond five years and therefore, helps to ensure consumers avoid the uninformed use of credit.

By contrast, consistent with statutory intent, proposed § 226.43(e)(2)(iv) seeks to ensure that the loan's payments are affordable for a reasonable period of time. For the reasons stated above, the Board believes that Congress intended the first five years after consummation to be a reasonable period of time to ensure that the consumer has the ability to repay the loan according to its terms. The Board also notes that the 2010 MDIA Interim Final Rule and 226.43(e)(2)(iv) complement, rather than conflict, with each other. That is, consistent with Congressional intent, proposed 226.43(e)(2)(iv) would ensure that a consumer could repay the loan for the first five years after consummation. For those borrowers that want to stay in the mortgage longer than five years, the disclosure required under the 2010 MDIA Interim Final Rule provides information about any potential increase in payments so that the consumer can decide whether those payments are affordable.

For these reasons, the Board believes it is appropriate to interpret the statutory text as requiring that the creditor underwrite the loan using the maximum interest rate during the first five years after consummation. The Board solicits comment on its interpretation of the phrase "first five years" and the appropriateness of this approach.

Proposed comment 43(e)(2)(iv)–1 would provide additional guidance to creditors on how to determine the maximum interest rate during the first five years after consummation. This comment would explain that creditors must use the maximum rate that could apply at any time during the first five years after consummation, regardless of whether the maximum rate is reached at the first or subsequent adjustment during such five year period. Proposed comment 43(e)(2)(iv)(A)–2 would clarify that for a fixed-rate mortgage, creditors should use the interest rate in effect at consummation, and provide a cross-reference to § 226.18(s)(7)(iii) for the meaning of the term "fixed-rate mortgage."

Proposed comment 43(e)(2)(iv)–3 would provide further guidance to creditors regarding treatment of periodic interest rate adjustment caps. This comment would explain that for an adjustable-rate mortgage, creditors should assume the interest rate increases after consummation as rapidly as possible, taking into account the terms of the legal obligation. This comment would further explain that creditors should account for any periodic interest rate adjustment cap that may limit how quickly the interest rate can increase under the terms of the legal obligation. This comment would also state that where a range for the maximum interest rate during the first five years is provided, the highest rate in that range is the maximum interest rate for purposes of this section. Finally, this comment would clarify that where the terms of the legal obligation are not based on an index plus a margin, or formula, the creditor must use the maximum interest rate that occurs during the first five years after consummation.

Proposed comment 43(e)(2)(iv)–3 provides several illustrative examples of how to determine the maximum interest rate. For example, this comment would illustrate how to determine the maximum interest rate in the first five years after consummation for an adjustable-rate mortgage with a discounted rate for three years. The example first assumes an adjustable-rate mortgage that has an initial discounted rate of 5% that is fixed for the first three years of the loan, after which the rate will adjust annually based on a specified index plus a margin of 3%. This comment assumes the index value in effect at consummation is 4.5%. This comment states that the loan agreement provides for an annual interest rate adjustment cap of 2%, and a lifetime maximum interest rate of 10%. The first rate adjustment occurs on the due date of the 36th monthly payment; the rate can adjust to no more than 7% (5% initial discounted rate plus 2% annual interest rate adjustment cap). The second rate adjustment occurs on the due date of the 48th monthly payment; the rate can adjust to no more than 9% (7% rate plus 2% annual interest rate adjustment cap). The third rate adjustment occurs on the due date of the 60th monthly payment, which occurs more than five years after consummation. This proposed comment explains that the maximum interest rate during the first five years after consummation is 9% (the rate on the due date of the 48th monthly payment).

[68] *See, e.g.,* Mortgage Reform and Anti-Predatory Lending Act, H. Rep. 111–94, p. 39 (2009).

Proposed comment 43(e)(2)(iv)–4 would further clarify the meaning of the phrase "first five years after consummation." This comment would reiterate that under proposed § 226.43(e)(2)(iv)(A), the creditor must underwrite the loan using the maximum interest rate that may apply during the first five years after consummation of the loan, and would provide the following illustrative example: Assume an adjustable-rate mortgage with an initial fixed interest rate of 5% for the first five years after consummation, after which the interest rate will adjust annually to the specified index plus a margin of 6%, subject to a 2% annual interest rate adjustment cap. The index value in effect at consummation is 5.5%. The loan consummates on September 15, 2011, and the first monthly payment is due on November 1, 2011. The first five years after consummation occurs on September 15, 2016. The first rate adjustment to no more than 7% (5% plus 2% annual interest rate adjustment cap) occurs on the due date of the 60th monthly payment, which is October 1, 2016 and therefore, the rate adjustment does not occur during the first five years after consummation. To meet the definition of qualified mortgage under § 226.43(e)(2), the creditor must underwrite the loan using a monthly payment of principal and interest based on an interest rate of 5%, which is the maximum interest rate during the first five years after consummation.

43(e)(2)(iv)(B) Amortizing Payments of Principal and Interest

Proposed § 226.43(e)(2)(iv)(B) implements TILA Section 129C(b)(2)(A)(iv) and (v), in part, and provides as a condition to meeting the definition of a qualified mortgage that the creditor underwrite the loan using periodic payments of principal and interest that will repay either (*1*) 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 occurs during the first five years after consummation; or (2) the loan amount over the loan term. *See* proposed § 226.43(e)(2)(iv)(B)(*1*) and (*2*).

TILA Section 129C(b)(2)(A)(iv) and (v) state that underwriting should be based "on a payment schedule that fully amortizes the loan over the loan term." The Board notes that unlike the payment calculation assumptions set forth for purposes of the general ability-to-repay rule under TILA Section 129C(a)(6), the underwriting conditions for purposes of meeting the definition of a qualified mortgage do not specify the loan amount that should be repaid, and do not define "loan term." For consistency and to facilitate compliance, the Board proposes to use the terms "loan amount" and "loan term" in proposed § 226.43(b)(5) and (b)(6), respectively, for purposes of this underwriting condition.

However, the Board believes that a loan that meets the definition of a qualified mortgage and which has the benefit of other safeguards, such as limits on loan features and fees, merits flexibility in the underwriting process. Accordingly, the Board proposes to permit creditors to underwrite the loan using periodic payments of principal and interest that will repay either the outstanding principal balance as of the date the maximum interest rate takes effect under the terms of the loan, or the loan amount as of the date of consummation. The Board believes permitting the former approach more accurately reflects the largest payment amount that the borrower would need to make under the terms of the loan during the first five years after consummation, where as the latter approach would actually overstate the payment amounts required. This approach sets a minimum standard for qualified mortgages, but affords creditors to choose either approach to facilitate compliance.

Proposed comment 43(e)(2)(iv)–5 would provide further clarification to creditors regarding the loan amount to be used for purposes of this second condition. This comment would explain that for a creditor to meet the definition of a qualified mortgage under proposed § 226.43(e)(2), the creditor must determine the periodic payment of principal and interest using the maximum interest rate permitted during the first five years after consummation that repays either (1) the outstanding principal balance as of the earliest date the maximum interest rate can take effect under the terms of the legal obligation, over the remaining term of the loan, or (2) the loan amount, as that term is defined in § 226.43(b)(5), over the entire loan term, as that term is defined in § 226.43(b)(6). This comment would provide illustrative examples for both approaches.

Proposed comment 43(e)(2)(iv)–7 provides illustrative examples of how to determine the periodic payment of principal and interest based on the maximum interest rate during the first five years after consummation under proposed § 226.43(e)(2)(iv). For example, this comment would illustrate the payment calculation rule for an adjustable-rate mortgage with discount for five years. This comment first assumes a loan in an amount of $200,000 that has a 30-year loan term. Second, the comment would assume that the loan agreement provides for a discounted interest rate of 6% that is fixed for an initial period of five years, after which the interest rate will adjust annually based on a specified index plus a margin of 3%, subject to a 2% annual interest rate adjustment cap.

The index value in effect at consummation is 4.5%. The loan consummates on March 15, 2011 and the first regular periodic payment is due May 1, 2011. Under the terms of the loan agreement, the first rate adjustment is on April 1, 2016 (the due date of the 60th monthly payment), which occurs more than five years after consummation of the loan. This proposed comment explains that the maximum interest rate under the terms of the loan during the first five years after consummation is 6%. *See* proposed comment 43(e)(2)(iv)–7.iii.

This comment concludes that the creditor will meet the definition of a qualified mortgage if it underwrites the loan using the monthly payment of principal and interest of $1,199 to repay the loan amount of $200,000 over the 30-year loan term using the maximum interest rate during the first five years of 6%.

The Board notes that in the case of an adjustable-rate mortgage with a fixed interest rate for the first five years after consummation, the creditor will use the fixed initial rate as the maximum interest rate to calculate the monthly payment using that will repay the loan amount, in accordance with requirements in proposed § 226.43(e)(2)(iv). Because the fixed initial rate does not adjust during the first five years after consummation, the outstanding principal balance at the end of the fifth year is equivalent to the balance of the loan amount, assuming the first 60 monthly payments under the loan are made as scheduled. Thus, there is no alternative calculation.

43(e)(2)(v)

Income or Assets (ALTERNATIVE 1) or Underwriting Requirements (ALTERNATIVE 2)

As discussed above, it is not clear whether the Act intends the definition of a "qualified mortgage" to be a somewhat narrowly-defined safe harbor or a more broadly-defined presumption of compliance. Thus, the Board is proposing two alternative requirements for the "qualified mortgage" definition. Under Alternative 1, the underwriting requirements for a qualified mortgage would be limited to what is contained in the statutory definition, namely, considering and verifying the consumer's current or reasonably expected income or assets. Under Alternative 2, the qualified mortgage definition would require a creditor consider and verify all of the underwriting criteria required under the general ability-to-repay standard, namely: (1) The consumer's current or reasonably expected income, (2) the consumer's employment status, (3) the monthly payment on any simultaneous loans, (4) the consumer's current debt obligations, (5) the consumer's monthly debt-to-income ratio or residual income, and (6) the consumer's credit history.

ALTERNATIVE 1

43(e)(2)(v) Income or Assets

Under TILA Section 129C(b)(2)(A)(iii), a condition for a "qualified mortgage" is that the income and financial resources relied upon to qualify the obligors on the residential mortgage loan are verified and documented. This requirement is consistent with the repayment ability requirement to consider and verify a consumer's income or assets using third-party records, under TILA Section 129C(a)(1) and (3), as discussed above in the section-by-section analysis of proposed § 226.43(c)(2)(i) and (c)(4). Proposed § 226.43(e)(2)(v) would implement TILA Section 129C(b)(2)(A)(iii) and provides that for a covered transaction to be a "qualified mortgage," the creditor must consider and verify the consumer's current or reasonably expected income or assets to determine the consumer's repayment ability, as required by proposed § 226.43(c)(2)(i) and (c)(4). The Board believes creditors must consider and not merely verify a consumer's income or assets for a covered transaction to be a "qualified mortgage," because TILA Section 129C(b)(2)(A)(iii) integrates a requirement to consider the consumer's income or assets by referring to qualifying a consumer for a covered transaction. Qualifying a consumer for a covered transaction in general involves considering whether or not the consumer's income or assets are sufficient for the consumer to meet his payment obligations under the covered transaction. In addition, the proposal uses the term "assets" instead of "financial resources" for consistency with other provisions in Regulation Z, as discussed above in the section-by-section analysis of proposed § 226.43(c)(2)(i). Under the first alternative requirement, proposed comment 43(e)(2)(v)–1 clarifies that creditors may rely on commentary to § 226.43(c)(2)(i), (c)(3) and (c)(4) for guidance regarding considering and verifying the consumer's income or assets to satisfy the conditions under § 226.43(e)(2)(v) for a "qualified mortgage."

ALTERNATIVE 2

43(e)(2)(v)(A)–(F) Underwriting Requirements

Under Alternative 2, proposed § 226.43(e)(2)(v) would implement TILA Section 129C(b)(2)(A)(iii) and require that creditors consider and verify the consumer's current or reasonably expected income or assets to determine the consumer's repayment ability, as required by proposed § 226.43(c)(2)(i) and (c)(4). This proposed requirement, which under Alternative 2 is designated § 226.43(e)(2)(v)(A), is discussed in detail under Alternative 1 above.

In addition, proposed § 226.43(e)(2)(v)—Alternative 2 would require that creditors consider and verify the following additional underwriting requirements, which are also required under the general ability-to-repay standard: The consumer's employment status, the consumer's monthly payment on any simultaneous loans, the consumer's current debt obligations, and the consumer's credit history. Creditors could look to commentary on the general repayment ability provisions under proposed § 226.43(c)(2)(i), (ii), (iv), and (vi) through (viii), and (c)(3), (c)(4), (c)(6), and (c)(7) for guidance regarding considering and verifying the consumer's repayment ability to satisfy the conditions under § 226.43(e)(2)(v) for a "qualified mortgage." *See* proposed comment 43(e)(2)(v)–1 (Alternative 2). The Board proposes these additions pursuant to its legal authority pursuant under TILA Section 129C(b)(3)(B)(i). The Board believes that adding these requirements may be necessary to better ensure that the consumers are offered and receive loans on terms that reasonably reflect their ability to repay the loan.

The Board solicits comments on adding each of these criteria to the definition of a "qualified mortgage." Specifically, the Board solicits comment on whether, for each criterion, the inclusion of the criterion strikes the appropriate balance between ensuring the consumer's ability to repay the loan and providing creditors with an incentive to make a qualified mortgage. In addition, the Board solicits comment on whether consideration of simultaneous loans should be required for both purchase transactions and non-purchase transactions (*i.e.,* refinancings).

43(e)(2)(v)(E) Debt-to-Income Ratio or Residual Income

TILA Section 129C(b)(2)(vi) states that the term "qualified mortgage" includes any mortgage loan "that complies with any guidelines or regulations established by the Board relating to ratios of total monthly debt to monthly income or alternative measure of ability to pay regular expenses after payment of total monthly debt, taking into account the income levels of the borrower and such other factors as the Board may determine relevant and consistent with the purposes described in paragraph (3)(B)(i)." As stated above, under proposed § 226.43(e)(2)(v)—Alternative 1, creditors are not required to consider the consumer's debt-to-income ratio or residual income to make a qualified mortgage. However, under proposed § 226.43(e)(2)(v)—Alternative 2, a "qualified mortgage" is a loan for which, among other things, the creditor considers the consumer's monthly debt-to-income ratio or residual income, as required by § 226.43(c)(2)(vii) and (c)(7). Without determining the consumer's debt-to-income ratio, a creditor could originate a qualified mortgage without any requirement to consider the effect of the new loan payment on the consumer's overall financial picture. The consumer could have a very high total debt-to-income ratio under widely accepted underwriting standards, and be predicted to default soon after the first scheduled mortgage payment. Accordingly, including the debt-to-income ratio or residual income in the definition of "qualified mortgage" might ensure that the consumer has a reasonable ability to repay the loan.

The Board solicits comment on whether consideration of the debt-to-income ratio or residual income should be part of the criteria for a "qualified mortgage."

Quantitative standards. The Board is not proposing a quantitative standard for the debt-to-income ratio or residual income in the qualified mortgage definition for several reasons. First, as explained in the Board's 2008 HOEPA Final Rule, the Board is concerned that setting a specific debt-to-income ratio or residual income level could limit credit availability without providing adequate off-setting benefits. 73 FR 44550, July 30, 2008. For this proposal, the Board analyzed data from the Applied Analytics division (formerly McDash Analytics) of Lender Processing Services (LPS) for the years 2005–2008 [69] and

[69] The LPS data include mortgage underwriting and performance information. The LPS data do not include detailed information on borrower income

data from the Survey of Consumer Finances (the SCF) for the years 2005–2007.[70] Using the LPS data, the Board found that about 23 percent of all borrowers exceeded a debt-to-income ratio of 45 percent, the typical maximum permitted by creditors and the secondary market for loans that are manually underwritten. The data show that this rate was even higher for borrowers living in low-income or high-cost areas. Using the SCF data, the Board found that about 44 percent of borrowers located in low-income areas and about 31 percent of borrowers located in high-cost areas exceeded the 45 percent limit.[71] If the Board were to adopt a quantitative standard, the Board seeks comment on what exceptions may be necessary for low-income borrowers or borrowers living in high-cost areas, or for other cases.

Second, outreach conducted by the Board revealed a range of underwriting guidelines for debt-to-income ratios based on product type, whether creditors used manual or automated underwriting, and special considerations for high- and low-income borrowers. Setting a quantitative standard would require the Board to address the operational issues related to the calculation of the debt-to-income ratio or residual income. For example, the Board would need clearly to define income and current debt obligations, as well as compensating factors and the situations in which creditors may use compensating factors, In addition, the debt-to-income ratio is often a floating metric, since the percentage changes as new information about income or current debt obligations becomes available. A quantitative standard would require guidelines on the timing of the debt-to-income ratio calculation, and what circumstances would necessitate a re-calculation of the debt-to-income ratio. Furthermore, a quantitative standard may also need to provide tolerances for mistakes made in calculating the debt-to-income ratio. The rule would also need to address the use of automated underwriting systems in determining the debt-to-income ratio or residual income.

Finally, setting a quantitative standard for residual income could prove particularly challenging. Except for one small creditor and the Department of Veterans' Affairs, the Board is not aware of any creditors that routinely use residual income in underwriting, other than as a compensating factor.[72] As noted in the supplementary information to the 2008 HOEPA Final Rule, the residual income guidelines of the Department of Veterans' Affairs may be appropriate for the limited segment of the mortgage market this agency is authorized to serve, but they are not necessarily appropriate for the large segment of the mortgage market this regulation will cover. 73 FR 44550, July 30, 2008. Moreover, the residual income guidelines developed by the Department of Veterans' Affairs have not been updated since 1997. It is not clear that such guidelines would be appropriate or provide sufficient flexibility for consumers outside the market served by the Department of Veterans' Affairs.

For these reasons, the Board is not proposing a quantitative standard for the debt-to-income ratio or residual income. The Board recognizes, however, that creditors, and ultimately consumers, may benefit from a higher degree of certainty surrounding the qualified mortgage definition that a quantitative standard could provide. Therefore, the Board solicits comment on whether and how it should prescribe a quantitative standard for the debt-to-income ratio or residual income for the qualified mortgage definition.

43(e)(3) Limits on Points and Fees for Qualified Mortgages

Proposed § 226.43(e)(3) sets forth two alternative proposals establishing the points and fees that a creditor may charge on a qualified mortgage:

Alternative 1

- For a loan amount of $75,000 or more, 3 percent of the total loan amount;
- For a loan amount of greater than or equal to $60,000 but less than $75,000, 3.5 percent of the total loan amount;
- For a loan amount of greater than or equal to $40,000 but less than $60,000, 4 percent of the total loan amount;
- For a loan amount of greater than or equal to $20,000 but less than $40,000, 4.5 percent of the total loan amount; and
- For a loan amount of less than $20,000, 5 percent of the total loan amount.

Alternative 2

- For a loan amount of $75,000 or more, 3 percent of the total loan amount;
- For a loan amount of greater than or equal to $20,000 but less than $75,000, a percent of the total loan amount not to exceed the percentage of the total loan amount yielded by the following formula—
  - Total loan amount − $20,000 = $Z
  - $Z × .0036 basis points = Y basis points
  - 500 basis points − Y basis points = X basis points
  - X basis points × .01 = *Allowable points and fees as a percentage of the total loan amount.*
- For a loan amount of less than $20,000, 5 percent of the total loan amount.

For both alternatives, Proposed comment 43(e)(3)(i)–1 cross-references comment 32(a)(1)(ii)–1 for an explanation of how to calculate the "total loan amount" under this provision. Proposed comment 43(e)(3)(i)–2 also clarifies that a creditor must determine which category the loan falls into based on the face amount of the note (the "loan amount"), but must apply the allowable points and fees percentage to the "total loan amount," which may be an amount that is different than the face amount of the note. Specifically, the comment explains that a creditor must calculate the allowable amount of points and fees for a qualified mortgage as follows:

- First, the creditor must determine the "tier" into which the loan falls based on the loan amount. The loan amount is the principal amount the consumer will borrow as reflected in the promissory note or loan contract. *See* § 226.43(b)(5). For example, if the loan amount is $75,000, the loan falls into the tier for loans of $75,000 or more, to which a three percent cap on points and fees applies.
- Second, the creditor must determine the "total loan amount" based on the calculation for the "total loan amount" under comment 32(a)(1)(ii)–1. If the loan amount is $75,000, for

and on other debts the borrower may have in addition to the mortgage.

[70] The SCF is conducted every three years by the Board, in cooperation with the U.S. Department of Treasury, to provide detailed information on the finances of U.S. families. The SCF collects information on the balance sheet, pension, income, and other demographic characteristics of U.S. families. To ensure the representativeness of the study, respondents are selected randomly using a scientific sampling methodology that allows a relatively small number of families to represent all types of families in the nation. Additional information on the SCF is available at *http://www.federalreserve.gov/pubs/oss/oss2/method.html.*

[71] *See also* Wardrip, Keith, *An Annual Look at the Housing Affordability Challenges of America's Working Households* (Center for Housing Policy 2011) (showing that just over 20 percent of working households, defined as households that report household members working at least 20 hours per week, on average, with incomes no higher than 120 percent of the median income in their area, who own a home spend more than half its income on housing costs).

[72] *See also* Stone, Michael E., *What is Housing Affordability? The Case for the Residual Income Approach,* 17 Housing Policy Debate 179 (Fannie Mae 2006) (advocating use of a residual income approach but acknowledging that it "is neither well known, particularly in this country, nor widely understood, let alone accepted").

example, the "total loan amount" may be a different amount, such as $73,000.

- Third, the creditor must apply the percentage cap on points and fees to the "total loan amount." For example, for a loan of $75,000 where the "total loan amount" is $73,000, the allowable points and fees is three percent of $73,000 or $2,190.

For a discussion of the Board's proposed revisions to the "total loan amount" calculation, see the section-by-section analysis of § 226.32(a)(1)(ii), above.

Discussion

The Board proposes the two alternative calculations for the qualified mortgage points and fees test to implement TILA Section 129C(b)(2)(A)(vii), which requires that the points and fees of a qualified mortgage may not exceed three percent of the total loan amount. 15 U.S.C. 1639c(b)(2)(A)(vii). Proposed § 226.43(e)(3) is also intended to implement TILA Section 129C(b)(2)(D), which requires the Board to adjust this three percent points and fees limit for "smaller loans" and also requires that, "[i]n prescribing such rules, the Board * * * consider the potential impact of such rules on rural areas and other areas where home values are lower." 15 U.S.C. 1639C(b)(2)(D). The statute does not define, and the legislative history does not provide guidance on, the terms "smaller loan" or the phrase "rural areas and other areas where home values are lower."

Therefore, to gather information on how best to implement the statutory requirement that the Board "adjust" the points and fees threshold for "smaller loans," Board staff consulted with consumer advocates and numerous types of creditors, including representatives of banks and credit unions in rural areas, as well as manufactured home loan creditors. In addition, Board staff also examined recent data on loan size distributions for home purchase loans and refinances by county and based on whether the loan was a conventional mortgage or a mortgage secured by manufactured homes. The Board also considered that creditors can, to some extent, increase the interest rate to offset limits on points and fees. The Board recognizes that loan pricing is typically a blend of points and fees and interest rate and that limits on points and fees tend to drive loan costs into the rate.

As an initial matter, the Board considered a few options for implementing the statutory mandate to "adjust[] the criteria" of the three percent points and fees cap—namely, narrowing the charges required to be included in the "points and fees" calculation, raising the percentage cap, or a combination of both. Outreach participants generally disfavored an approach that would require different ways of calculating points and fees depending on loan size. Industry representatives in particular raised concerns about compliance burden and the increased risk of error resulting from a more complex rule. The Board believes that requiring separate ways of calculating points and fees is unnecessary to effect the statutory mandate to "adjust the criteria" for the qualified mortgage three percent points and fees threshold. The proposal therefore simply would set higher percentage caps on points and fees for loans of less than $75,000.

Outreach participants had varying views on appropriate loan size thresholds for an alternative points and fees limitation applicable to "smaller loans." Industry representatives shared a concern that loans below a certain size could not meet the three percent points and fees cap because the minimum costs to originate any loan would exceed three percent of loans of that size. While recognizing that loan costs can be covered in part by charging a higher interest rate, creditors were concerned that for smaller loans, the needed rate increase might result in loan becoming a high-cost mortgage; as a result, creditors would be reluctant to make these loans and credit availability would be compromised. Based on calculations using loans in their own portfolios, some creditors indicated that the point at which minimum loan origination costs exceed three percent of the total loan amount is $50,000 to $75,000. At least one creditor indicated that, in addition, for loans of $40,000 or less, the creditor would be unable to meet a four percent cap on points and fees. Others suggested $100,000 as the appropriate "smaller loan" threshold, while still others recommended that the Board propose a "smaller loan" threshold of greater than $100,000, such as at least $150,000. Community bank representatives in particular raised concerns that they would be unable to retain profitability without an adjustment to the points and fees cap for loans of less than $100,000. They argued that the sizes of loans originated by community banks and other institutions in less populated areas are "small" on average, leaving less opportunity for community banks than larger institutions to make up any losses on originations of small loans through originations of larger loans.

Industry representatives also generally expressed concerns about limiting the availability of credit to low-income or rural borrowers if the points and fees cap for qualified mortgages were too low with respect to "smaller loans." If creditors could not meet the qualified mortgage points and fees cap, these loans would not meet the definition of a "qualified mortgage" and creditors therefore would be less likely to make these loans.

Consumer advocates generally favored a narrower exception to the three percent qualified mortgage points and fees threshold for "smaller loans," recommending a "smaller loan" size of no higher than $50,000 and preferably lower. They questioned industry concerns that the three percent threshold would limit the availability of credit for borrowers of comparatively low loan amounts. Instead, they emphasized the importance of ensuring that qualified mortgages are affordable because, depending on the Board's interpretation of the statute, these loans potentially would not be subject to some or all of the specific repayment ability requirements in TILA Section 129C(a) (*see* proposed § 226.43(c)). (For a detailed discussion of the Board's alternative proposals regarding which of the general repayment ability requirements apply to creditors of qualified mortgages, see the section-by-section analysis of proposed § 226.43(e), above.) In their view, the three percent points and fees cap is a centerpiece of ensuring affordability and should be relaxed only in very limited circumstances.

The Board's Proposal

Based on outreach and the Board's research, the Board is issuing two alternative proposals to implement the points and fees limitation on qualified mortgages. The first consists of five "tiers" of loan sizes and corresponding limits on points and fees. The second consists of three "tiers," with the middle tier of allowable points and fees based on a formula yielding a greater allowable percentage of the total loan amount to be charged in points and fees for each dollar increase in loan size.

The Board proposes a "tiered" approach, rather than a single "smaller loan" threshold and a single alternate points and fees cap for loans at or below that amount, for several reasons. First, the Board understands that most creditors have a minimum cost for originating a mortgage loan of any size and that this cost may vary somewhat by creditor. If a single minimum origination cost is assumed, that cost will obviously comprise a different percentage of a loan depending on its size. Total points and fees of $2,500 will obviously be a smaller percentage of a loan of $100,000 (2.5%) than for a loan of $50,000 (5%), for example. A single threshold therefore may not be sufficiently flexible to allow loans of a full range of sizes to be deemed qualified mortgages.

In addition, the Board believes that a rule allowing for incremental increases in the points and fees cap for several ranges of loan sizes will help mitigate market distortions that might otherwise result. For example, a rule setting a five percent points and fees cap for all loans less than $75,000 would create a significant disparity between the amount of points and fees that could be charged on loans of substantially equal amounts. For a loan of $75,000, for instance, a creditor could charge up to $2,250 (3% of $75,000). But for a loan of $74,000, a creditor could charge as much as $3,700 (5% of $74,000). As a result, loans slightly above the threshold at which a five percent cap applies—for example, from $75,000 to $85,000—might be less likely to be made at all.

Finally, the Board is reluctant to require a single threshold due to limitations inherent in available data on origination costs. Various resources that track points and fees in loan originations tend to use different methods for calculating the points and fees and to date do not include all items that must be counted as points and fees under TILA as amended by the Dodd-Frank Act. *See* TILA Section 103(aa)(4); 15 U.S.C. 1602(aa)(4). *See also* section-by-section analysis of § 226.32, above.

Alternative 1. The five-tiered approach proposed as Alternative 1 is intended to facilitate compliance by setting clear categories based on loan size to which specific points and fees thresholds apply. The Board derived the loan size ranges for each category (with corresponding points and fees thresholds of three percent, 3.5 percent, four percent, 4.5 percent, and five percent of the "total loan amount," respectively) based on a calculation that would generally achieve a "sliding scale" points and fees cap from three to five percent for loans from $20,000 to $75,000. To make the proposal more straightforward, the Board chose increments of .5% and rounded the loan size ranges proposed for each category. Thus, for example:

- An $80,000 loan would fall into the category for loans of $75,000 or more, to which a three percent points and fees rate cap applies. Assuming that the "total loan amount" for the loan is also $80,000, the dollar amount of allowable points and fees for this loan would be $2,400.
- A $60,000 loan would fall into the category for loans of $60,000 but less than $75,000, to which a 3.5 percent points and fees rate cap applies. Assuming that the "total loan amount" for the loan is also $60,000, the dollar amount of allowable points and fees for this loan would be $2,100.
- A $40,000 loan would fall into the category for loans of $40,000 but less than $60,000, to which a four percent points and fees rate cap applies. Assuming that the "total loan amount" for the loan is also $40,000, the dollar amount of allowable points and fees for this loan would be $1,600.
- A $20,000 loan would fall into the category for loans of $20,000 but less than $40,000, to which a 4.5 percent points and fees rate cap applies. Assuming that the "total loan amount" for the loan is also $40,000, the dollar amount of allowable points and fees for this loan would be $900.
- A $10,000 loan would fall into the category for loans of less than $20,000, to which a five percent points and fees rate cap applies. Assuming that the "total loan amount" for the loan is also $10,000, the dollar amount of allowable points and fees for this loan would be $500.

Proposed alternative comment 43(e)(3)(i)–3 provides the following illustration of how to calculate the allowable points and fees for a $50,000 loan with a $48,000 total loan amount: A covered transaction with a loan amount of $50,000 falls into the third points and fees tier, to which a points and fees cap of 3.5 percent of the total loan amount applies. *See* § 226.43(e)(3)(i)(C). If a $48,000 total loan amount is assumed, the allowable points and fees for this loan is 3.5 percent of $48,000 or $1,920.

One concern is that this approach yields anomalous results in some instances—namely, that a greater dollar amount of points and fees would be allowable on some loans than on other loans of a larger size. For example, the allowable points and fees that could be charged on a loan of $40,000 (also assuming in this example a "total loan amount" of $40,000) would be $1,600—four percent of the total loan amount. At the same time, the allowable points and fees that could be charged on a loan of $38,000 (also assuming in this example a "total loan amount" of $38,000) would be $1,710—4.5 percent of the total loan amount. The Board considered and could revise the first alternative to solve the anomalies mathematically, but not without adding significant complexity to the regulation, which in turn would increase the risk of compliance errors. For these reasons, the Board is also proposing the alternative discussed below.

Alternative 2. The Board proposes an alternative with three tiers that incorporates a formula designed to ensure that allowable points and fees as a dollar amount will increase as the loan amount increases, thus eliminating the anomalies resulting from the proposed five-tier approach. Specifically, as noted, for a loan amount of $75,000 or more, allowable points and fees would be 3 percent of the total loan amount. For a loan amount of less than $20,000, allowable points and fees would be 5 percent of the total loan amount. These two categories correspond with the first and last tiers of the five-tiered approach discussed above.

For a loan amount of greater than or equal to $20,000 but less than $75,000, however, the allowable points and fees would be a percentage of the total loan amount not to exceed the amount yielded by the following formula—

- ○ Total loan amount − $20,000 = $Z
- ○ $Z × .0036 = Y basis points
- ○ 500 basis points − Y basis points = X basis points
- ○ X basis points × .01 = *Allowable points and fees as a percentage of the total loan amount.*

In effect, for every dollar increase in the total loan amount, the allowable points and fees would increase by .0036 basis points. Proposed alternative comment 43(e)(3)(i)–3 provides the following illustration of how to apply this formula: Assume a loan amount of $50,000 with a "total loan amount" of $48,000. The amount of $20,000 must be subtracted from $48,000 to yield the number of dollars to which the .0036 basis points multiple must be applied—in this case, $28,000. $28,000 must be multiplied by .0036 basis points—in this case resulting in 100.8 basis points.

This amount must be subtracted from the maximum allowable points and fees on any loan, which, under the proposed rule, is 500 basis points. (Five percent of the total loan amount for loans of less than $20,000 is the maximum allowable points and fees on any loan. Five percent expressed in basis points is 500.) Five hundred minus 100.8 equals 399.2 basis points: This is the allowable points and fees in basis points. Translating basis points into a percentage of the total loan amount requires multiplying 399.2 by .01—resulting, in this case, in 3.99 percent. Allowable points and fees for this loan as a dollar figure is therefore 3.99 percent of $48,000 (*i.e.,* the total loan amount), or $1,915.20.

The Board recognizes that a formula is potentially more complex for creditors to comply with than the multiple tiers proposed under the first alternative. In particular, the Board requests comment on whether a formula would be difficult for smaller creditors to integrate into their lending operations.

Three to five percent cap. The upper end of the points and fees cap for smaller loans is proposed to be five percent for loans of less than $20,000. One reason for the maximum cap of five percent for loans of less than $20,000 is to achieve general consistency with the Dodd-Frank Act amendments to the points and fees thresholds for high-cost mortgages.[73] Specifically, TILA now defines a high-cost mortgage as one for which the points and fees equal five percent of the total transaction amount if the transaction is $20,000 or more and, if the transaction is less than $20,000, the lesser of eight percent of the total transaction amount or $1,000. *See* TILA Section 103(aa)(1)(A)(ii)(I) and (II); 15 U.S.C. 1602(aa)(1)(A)(ii)(I) and (II).

The proposal seeks to ensure that if a loan is a qualified mortgage, it would not also be a high-cost mortgage based on the points and fees, and therefore subject to the more stringent high-cost mortgage rules of TILA Section 129 (as amended by the Dodd-Frank Act).[74] For example, five percent of a loan of $19,999 is $999.95. Thus, for this loan to meet the points and fees test for qualified mortgages, the maximum points and fees that could be charged would be $999.95. If the maximum points and fees that could be charged on this loan under the qualified mortgage test were $1,000, this loan would also be a high-cost mortgage.

As discussed earlier, the Board believes that the statute is designed to reduce the compliance burden on creditors when they make qualified mortgages, in order to encourage creditors to make loans with stable, understandable loan features. Creating points and fees thresholds for small loans that might result in qualified mortgages also being high-cost mortgages would discourage creditors from making qualified mortgages because the requirements and limitations of high-cost loans are generally more stringent than for other loans. High-cost mortgages, for example, are subject to a cap on the late fees that may be imposed and timing restrictions regarding when the fee may be imposed, but other mortgages are not subject to these and several other rules applicable solely to high-cost mortgages. *See* TILA Section 129(k); 15 U.S.C. 1639(k). They also require that the consumer obtain "pre-loan counseling" not required for other mortgages. *See* TILA Section 129(u); 15 U.S.C. 1639(u).

Three percent cap for loans of $75,000 or greater. The Board proposes a loan size of $75,000 as the point at which the statutory three percent points and fees cap begins to apply for several reasons. First, the Board believes that Congress intended the exception to the qualified mortgage points and fees cap to affect more than a minimal—although still limited—proportion of home-secured loans. The 2008 Home Mortgage Disclosure Act[75] (HMDA) data show that 8.4 percent of first-lien, home-purchase (site-built) mortgages had a loan amount of $74,000 or less.[76] That percentage significantly drops for loans of $49,000 or less, to 2.8 percent, with only .5 percent of all loans at $24,000 or less. The percentage of first-lien, home-purchase (site-built) mortgages of $100,000 or less is significantly higher than 8.4 percent, however—totaling 16 percent of the market.

Similarly, in 2009, the percentage of first-lien *home-purchase* (site-built) mortgages was 9.7 percent, with a significant drop for loans of $50,000 or less to 3.3 percent of the total market and .3 percent for loans of $20,000 or less.[77] Again, however, the percentage of first-lien home-purchase (site-built) mortgages jumps substantially—from 9.7 percent to 18.5 percent—for loans of $100,000 or less. Parallel results occurred for first-lien *refinances* secured by site-built homes.[78]

Thus, the Board believes that a loan size of less than $75,000 would capture a material portion of the first-lien home-purchase (site-built) mortgage market (close to 10 percent), but would not undermine the statute by creating an exception that might be over-broad.[79]

Second, Board outreach and research indicate that $2,250—three percent of $75,000—is within range of average costs to originate a first-lien home mortgage. Thus $75,000 appears to be an appropriate benchmark for applying the three percent limit, with a higher percent limit applying to loans below that amount to afford creditors of these loans a reasonable opportunity to recoup their origination costs. The sliding scale approach to loans below $75,000 is intended in part to help ensure that creditors of these loans would not have to add a significant amount to the rate to recoup their origination costs and thus cannot be classified as high-cost mortgages. In addition, the Board seeks to limit compensating rate increases because it recognizes that increasing the rate is not necessarily in the consumer's interest—for example, a loan with a higher rate can be costly for a consumer who plans to stay in the home (and loan) for a long time. Higher rates also can decrease credit access because some consumers may not be able to make the resulting payments over time, but may have the cash to pay the costs upfront.

Third, the Board interprets Congress's express concern for "loans in areas where home values are lower" to encompass not only geographic areas but also "areas" of mortgage lending generally—in particular, property types such as manufactured homes, which tend to be less expensive than site-built homes. Regarding property types, the Board focused on manufactured homes and found that, in 2009, 74.8 percent of all first-lien home-purchase loans secured by manufactured homes were $75,000 or less, while 61.8 percent of all first-lien refinances secured by manufactured homes were $75,000 or less. Thus the Board believes that the proposal would appropriately address Congress's concern with the "lower" home values typical of manufactured homes. The Board considers manufactured homes to be an important homeownership option for many consumers and intends through this proposal to protect manufactured home loan consumers from excessive costs, while allowing more of these loans to be deemed qualified mortgages.

In general, the Board is reluctant to propose an adjustment to the three percent qualified mortgage points and fees cap based on geographic area alone. Property values shift over time, and in some cases, properties in what today are

[73] Public Law 111–203, 124 Stat. 1376, Title XIV, § 1431.

[74] *Id.* § 1432, 1433.

[75] 12 U.S.C. 2801 *et seq.*

[76] *See* The 2008 HMDA Data: The Mortgage Market during a Turbulent Year, *Federal Reserve Bulletin,* vol. 95, p. A201 (April 2010).

[77] *See* HMDA data for 2009 is available at Federal Financial Institutions Examination Council, *http://www.ffiec.gov.hmda/hmdaproducts.htm.*

[78] *See* The 2008 HMDA Data: The Mortgage Market during a Turbulent Year, *Federal Reserve Bulletin,* vol. 95, p. A201 (April 2010); Federal Financial Institutions Examination Council, *http://www.ffiec.gov/hmda/hmdaproducts.htm*

[79] The proposed loan size threshold would have applied to the majority of second-lien home-purchase and refinance loans secured by site-built homes in 2008 and 2009. In 2008, 78.3 percent of all second-lien home-purchase (site-built) mortgages were $74,000 or less and 75.3 percent of all second-lien refinances (site-built) were $74,000 or less. *See* The 2008 HMDA Data: The Mortgage Market during a Turbulent Year, *Federal Reserve Bulletin,* vol. 95, p. A201 (April 2010). In 2009, 85.1 percent of all second-lien home-purchase (site-built) and 78.1 percent of all second-lien refinance (site-built) mortgages were in an amount of $75,000 or less. *See* Federal Financial Institutions Examination Council, *http://www.ffiec.gov/hmda/hmdaproducts.htm.*

remote, inexpensive areas may become more populated and costly over time. The Board considered imposing an alternate points and fees threshold for defined geographic areas such as "non-MSA" areas. However, even within those areas, origination costs and loan sizes may vary widely, so the Board believes that an inadequate basis exists for such a proposal.

Nevertheless, regarding whether loan sizes are "lower" on average in some geographic areas than others, the Board has conducted preliminary research on loan size by county. HMDA data indicate that in 2009, for example, there were eight counties in which loans under $75,000 comprised more than 90 percent of all first-lien mortgages made in those counties, and 1,366 counties in which loans under $75,000 comprised more than 90 percent of all second-lien loans made in those counties.[80] The Board also noted that counties in which at least 70 percent of second-lien mortgages made were under $75,000 (2,616 counties) accounted for 91 percent of the entire second-lien mortgage market for loans of under $75,000. These data suggest that the proposal may affect access to credit differently across the country.

The Board requests comment on the proposed alternative loan size ranges and corresponding points and fees caps for qualified mortgages. The Board encourages commenters to provide specific data to support their recommendations. The Board also solicits comment on whether the proposal should index the loan size ranges for inflation and periodically change them by regulation. In addition, the Board requests comment on the potential impact of the proposal on access to credit, particularly on how the impact may vary based on geographic area.

43(e)(3)(ii) Exclusions From Points and Fees for Qualified Mortgages

Proposed § 226.43(e)(3)(ii) excludes three types of charges from the points and fees calculation for qualified mortgages:

- Any bona fide third party charge not retained by the creditor, loan originator, or an affiliate of either, subject to the limitations under proposed § 226.32(b)(1)(i)(B), which requires that premiums for private mortgage insurance be included in points and fees under certain circumstances, even if they are not retained by the creditor, loan originator, or an affiliate of either.
- Up to two bona fide discount points paid by the consumer in connection with the covered transaction, but only if certain conditions are met (discussed below).
- Up to one bona fide discount point paid by the consumer in connection with the covered transaction, but only if certain conditions are met (discussed below).

See proposed § 226.43(e)(3)(ii)(A)–(C).

43(e)(3)(ii)(A) Bona Fide Third Party Charges

Proposed § 226.43(e)(3)(ii)(A) excludes from "points and fees" for qualified mortgages "any bona fide third party charge not retained by the creditor, loan originator, or an affiliate of either, unless the charge is required to be included in 'points and fees' under § 226.32(b)(1)(i)(B)." This provision would implement TILA Section 129C(b)(2)(C), which defines "points and fees" for qualified mortgages to have the same meaning as "points and fees" for high-cost mortgages (TILA Section 103(aa)(4)), but expressly excludes "bona fide third party charges not retained by the mortgage originator, creditor, or an affiliate of the creditor or mortgage originator." 15 U.S.C. 1602(aa)(4), 1639c(b)(2)(C). With the following example, proposed comment 43(e)(3)(ii)–1 clarifies the meaning of "retained by" the loan originator, creditor, or an affiliate of either: If a creditor charges a consumer $400 for an appraisal conducted by a third party not affiliated with the creditor, pays the third party appraiser $300 for the appraisal, and retains $100, the creditor may exclude $300 of this fee from "points and fees" but must count the $100 it retains in "points and fees."

Proposed § 226.43(e)(3)(ii)(A) would also implement TILA Section 103(aa)(1)(C), which requires that premiums for private mortgage insurance be included in "points and fees" as defined in TILA Section 103(aa)(4) under certain circumstances. 15 U.S.C. 1602(aa)(1)(C). Applying general rules of statutory construction, the Board believes 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." Thus, comment 43(e)(3)(ii)–2 explains that § 226.32(b)(1)(i)(B) requires creditors to include in "points and fees" premiums or charges payable at or before closing for any private guaranty or insurance protecting the creditor against the consumer's default or other credit loss to the extent that the premium or charge exceeds the amount payable under policies in effect at the time of origination under Section 203(c)(2)(A) of the National Housing Act (12 U.S.C. 1709(c)(2)(A)). These premiums or charges must also be included if the premiums or charges are not required to be refundable on a pro-rated basis, or the refund is not automatically issued upon notification of the satisfaction of the underlying mortgage loan. The comment clarifies that, under these circumstances, even if the premiums and charges are not retained by the creditor, loan originator, or an affiliate of either, they must be included in the "points and fees" calculation for qualified mortgages. The comment also cross-references comments 32(b)(1)(i)–3 and –4 for further discussion of including upfront private mortgage insurance premiums in the points and fees calculation.

For a detailed discussion of the Board's proposal to apply the Dodd-Frank Act provisions on mortgage insurance to the meaning of "points and fees" for qualified mortgages, see the section-by-section analysis of proposed § 226.32(b)(1)(i) (implementing TILA Section 103(aa)(1)(C)).

43(e)(3)(ii)(B) and 43(e)(3)(ii)(C) Bona Fide Discount Points

Proposed § 226.43(e)(3)(ii)(B) and (e)(3)(ii)(C) permit a creditor to exclude a limited number of discount points from the calculation of points and fees under specific circumstances. These provisions are proposed to implement TILA Section 129C(b)(2)(C)(ii), (iii), and (iv), and mirror the statutory language with minor clarifying revisions. 15 U.S.C. 1639c(b)(2)(C)(ii), (iii), and (iv).

Exclusion of up to two bona fide discount points. Specifically, proposed § 226.43(e)(3)(ii)(B) permits a creditor to exclude from points and fees for a qualified mortgage up to two bona fide discount points paid by the consumer in connection with the covered transaction, provided that the following conditions are met—

- The interest rate before the rate is discounted does not exceed the average prime offer rate, as defined in § 226.45(a)(2)(ii),[81] by more than one percent; and
- The average prime offer rate used for purposes of paragraph 43(e)(3)(ii)(B)(*1*) is the same average prime offer rate that applies to a comparable transaction as of the date

[80] *See* Federal Financial Institutions Examination Council, *http://www.ffiec.gov/hmda/hmdaproducts.htm.*

[81] *See* 76 FR 11319, March 2, 2011 (2011 Jumbo Loan Escrow Final Rule).

the discounted interest rate for the covered transaction is set.

Proposed comment 43(e)(3)(ii)–3 provides the following example to illustrate this rule: Assume a covered transaction that is a first-lien, purchase money home mortgage with a fixed interest rate and a 30-year term. Assume also that the consumer locks in an interest rate of 6.00 percent on May 1, 2011, that was discounted from a rate of 6.50 percent because the consumer paid two discount points. Finally, assume that the average prime offer rate (APOR) as of May 1, 2011 for first-lien, purchase money home mortgages with a fixed interest rate and a 30-year term is 5.50 percent.

In this example, the creditor may exclude two discount points from the "points and fees" calculation because the rate from which the discounted rate was derived exceeded APOR for a comparable transaction as of the date the rate on the covered transaction was set by only one percent.

Exclusion of up to one bona fide discount point. Proposed § 226.43(e)(3)(ii)(C) permits a creditor to exclude from points and fees for a qualified mortgage up to one bona fide discount point paid by the consumer in connection with the covered transaction, provided that the following conditions are met—

• The interest rate before the discount does not exceed the average prime offer rate, as defined in § 226.45(a)(2)(ii),[82] by more than two percent;

• The average prime offer rate used for purposes of § 226.43(e)(3)(ii)(C)(*1*) is the same average prime offer rate that applies to a comparable transaction as of the date the discounted interest rate for the covered transaction is set; and

• Two bona fide discount points have not been excluded under § 226.43(e)(3)(ii)(B) of this section.

Proposed comment 43(e)(3)(ii)–4 provides the following example to illustrate this rule: Assume a covered transaction that is a first-lien, purchase money home mortgage with a fixed interest rate and a 30-year term. Assume also that the consumer locks in an interest rate of 6.00 percent on May 1, 2011, that was discounted from a rate of 7.00 percent because the consumer paid four discount points. Finally, assume that the average prime offer rate (APOR) as of May 1, 2011 for first-lien, purchase money home mortgages with a fixed interest rate and a 30-year term is 5.00 percent.

In this example, the creditor may exclude one discount point from the "points and fees" calculation because the rate from which the discounted rate was derived (7.00 percent) exceeded APOR for a comparable transaction as of the date the rate on the covered transaction was set (5.00 percent) by only two percent.

Comparable transaction. Both proposed exclusions for bona fide discount points require the creditor to determine the APOR for a "comparable transaction." Comment 43(e)(3)(ii)–5 clarifies that the APOR table published by the Board indicates how to identify the comparable transaction.[83] This comment also cross-references proposed comment 45(a)(2)(ii)–2 contained in the 2011 Escrow Proposal (*see also* existing comment 35(a)(2)–2), which makes the same clarification in a different context. Currently, the APOR table published by the Board indicates that one loan characteristic on which the APOR may vary is whether the rate is fixed or adjustable. Another variable is the length of the loan term. For a fixed-rate mortgage, the relevant term is the length of the entire contractual obligation, such as 30 years. For an adjustable-rate mortgage, the relevant term is the length of the initial fixed-rate period. The examples provided in proposed comments 43(e)(3)(ii)–3 and –4 are based on a fixed-rate mortgage with a 30-year term and accordingly refer to the APOR for a fixed-rate mortgage with a 30-year term.

Risk-based price adjustments. The Board is aware that, in setting the purchase price for specific loans, Fannie Mae and Freddie Mac make loan-level price adjustments (LLPAs) to compensate offset added risks, such as a high LTV or low credit score, among many other risk factors.[84] Creditors may, but are not required to, pass the resulting costs directly through to the consumer in the form of points. During outreach, some creditors argued that these points should not be counted in points and fees for qualified mortgages under the exclusion for "bona fide third party charges not retained by the loan originator, creditor, or an affiliate of either." Proposed § 226.43(e)(3)(ii)(A); TILA Section 129C(b)(2)(C).

The Board understands creditors' concerns about exceeding the qualified mortgage points and fees thresholds due to LLPAs required by the GSEs. At the same time, the Board questions whether an exemption for LLPAs is consistent with congressional intent in limiting points and fees for qualified mortgages. Points charged to meet GSE risk-based price adjustment requirements are arguably no different than other points charged on loans sold to any secondary market purchaser to compensate that purchaser for added loan-level risks. Congress clearly contemplated that discount points generally should be included in points and fees for qualified mortgages; as discussed above, the Dodd-Frank Act exempts from the qualified mortgage points and fees calculation up to only two discount points, and under limited circumstances. *See* TILA Section 129C(b)(2)(C)(ii), (iii), and (iv), proposed to be implemented in new § 226.43(e)(3)(ii)(B) and (e)(3)(ii)(C).

An exclusion for points charged by creditors in response to secondary market LLPAs also raises questions about the appropriate treatment of points charged by creditors to offset loan-level risks on mortgage loans that they hold in portfolio. Under normal circumstances, these points are retained by the creditor, so an argument that they should be excluded from points and fees under the "bona fide third party charge" exclusion (see above) seems inapt. Yet requiring that these points be included in points and fees, when similar charges on loans sold into the secondary market are excluded, may create undesirable market imbalances between loans sold to the secondary market and loans held in portfolio.

Creditors may offset risks on their portfolio loans (or on loans sold into the secondary market) by charging a higher rate rather than additional points and fees; however, the Board recognizes the limits of this approach to loan-level risk mitigation due to concerns such as exceeding high-cost mortgage rate thresholds. Nonetheless, in practice, an exclusion from the qualified mortgage points and fees calculation for all points charged to offset loan-level risks may create compliance and enforcement difficulties. The Board questions whether meaningful distinctions between points charged to offset loan-level risks and other points and fees charged on a loan can be made clearly and consistently. In addition, such an exclusion could be overbroad and inconsistent with Congress's intent that points generally be counted toward the points and fees threshold for qualified mortgages.

The Board requests comment on whether and on what basis the final rule should exclude from points and fees for qualified mortgages points charged to meet risk-based price adjustment requirements of secondary market purchasers and points charged to offset

[82] *See id.*

[83] Federal Financial Institutions Examination Council (FFIEC), "FFIEC Rate Spread Calculator," *http://www.ffiec.gov/ratespread/newcalc.aspx.*

[84] *See e.g.,* Fannie Mae, "Loan-Level Price Adjustment (LLPA) Matrix and Adverse Market Delivery Charge (AMDC) Information," *Selling Guide* (Dec. 23, 2010).

loan-level risks on mortgages held in portfolio.

43(e)(3)(iii) Definition of Loan Originator

Proposed § 226.43(e)(3)(iii) defines the term "loan originator" in § 226.43(e)(3) to have the same meaning as in § 226.36(a)(1). For a discussion of the Board's proposal to use the term "loan originator" as defined in § 226.36(a)(1) rather than the statutory term "mortgage originator," see the section-by-section analysis of proposed § 226.32(b)(1)(ii).

43(e)(3)(iv) Definition of Bona Fide Discount Point

Proposed § 226.43(e)(3)(iv) defines the term "bona fide discount point" as used in the exclusions of certain "bona fide discount points" from "points and fees" for qualified mortgages described above. This provision is intended to implement TILA Section 129C(b)(2)(C)(iii), which defines the term "bona fide discount point," as well as TILA Section 129C(b)(2)(C)(iv), which limits the types of discount points that may be excluded from "points and fees" to those for which "the amount of the interest rate reduction purchased is reasonably consistent with established industry norms and practices for secondary market transactions." 15 U.S.C. 1639c(b)(2)(C)(iii) and (iv).

Thus, "bona fide discount point" is proposed to be defined as "any percent of the loan amount" paid by the consumer that reduces the interest rate or time-price differential applicable to the mortgage loan by an amount based on a calculation that—

- Is consistent with established industry practices for determining the amount of reduction in the interest rate or time-price differential appropriate for the amount of discount points paid by the consumer; and
- Accounts for the amount of compensation that the creditor can reasonably expect to receive from secondary market investors in return for the mortgage loan.

Consistent with the express statutory language, the Board's proposal requires that the creditor be able to show a relationship between the amount of interest rate reduction purchased by a discount point to the value of the transaction in the secondary market. Based on outreach with representatives of creditors and government-sponsored enterprises (GSEs) in particular, the Board understands that the value of a rate reduction in a particular mortgage transaction on the secondary market is based on many complex factors, which interact in a variety of complex ways. These factors may include, among others:

- The product type, such as whether the loan is a fixed-rate or adjustable-rate mortgage, or has a 30-year term or a 15-year term.
- How much the mortgage-backed securities (MBS) market is willing to pay for a loan at that interest rate and the liquidity of an MBS with loans at that rate.
- How much the secondary market is willing to pay for excess interest on the loan that is available for capitalization outside of the MBS market.
- The amount of the guaranty fee required to be paid by the creditor to the investor.

The proposal therefore is intended to facilitate compliance by affording flexibility, while still requiring, as mandated by the statute, that the amount of discount points paid by consumers for a particular interest rate reduction be tied to the capital markets. The Board is concerned that a more prescriptive interpretation would be operationally unworkable for most creditors and would lead to excessive legal and regulatory risk. In addition, the Board recognizes that, due to the variation in inputs described above, a more prescriptive rule likely would require continual updating, creating additional compliance burden and potential confusion.

Concerns have been raised that small creditors such as community banks that often hold loans in portfolio rather than sell them on the secondary market may have difficulty complying with this requirement. The Board requests comment on whether any exemptions from the requirement that the interest rate reduction purchased by a "bona fide discount point" be tied to secondary market factors are appropriate.

43(f) Balloon-Payment Qualified Mortgages Made by Certain Creditors

As discussed above, under this proposal, a qualified mortgage generally may not provide for a balloon payment. TILA Section 129C(b)(2)(E), however, authorizes the Board to permit qualified mortgages with balloon payments, provided the loans meet four conditions. Those conditions are that (1) the loan meets all of the criteria for a qualified mortgage, with certain exceptions discussed in the more detailed section-by-section analysis, below; (2) the creditor makes a determination that the consumer is able to make all scheduled payments, except the balloon payment, out of income or assets other than the collateral; (3) the loan is underwritten based on a payment schedule that fully amortizes the loan over a period of not more than 30 years and takes into account all applicable taxes, insurance, and assessments; and (4) the creditor meets four prescribed qualifications. Those four qualifications are that the creditor (1) operates predominantly in rural or underserved areas; (2) together with all affiliates, has total annual residential mortgage loan originations that do not exceed a limit set by the Board; (3) retains the balloon-payment loans in portfolio; and (4) meets any asset-size threshold and any other criteria the Board may establish.

Based on outreach, certain community banks appear to originate balloon-payment loans to hedge against interest rate risk, rather than making adjustable-rate mortgages. The Board understands that the community banks hold these balloon-payment loans in portfolio virtually without exception because they are not eligible for sale in the established secondary market. The Board believes Congress enacted the exception in TILA Section 129C(b)(2)(E) to ensure access to credit in rural and underserved areas where consumers may be able to obtain credit only from such community banks offering these balloon-payment loans. Accordingly, proposed § 226.43(f) implements TILA Section 129C(b)(2)(E) by providing an exception to the general provision that a qualified mortgage may not provide for a balloon payment.

Proposed § 226.43(f)(1) sets forth the four statutory conditions described above, as well as an additional condition that the loan term be five years or longer, which the Board is proposing pursuant to its authority to "revise, add to, or subtract from the criteria that define a qualified mortgage" under TILA Section 129C(b)(3)(B)(i). Proposed § 226.43(f)(2) provides definitions of "rural" and "underserved" for use in determining whether the creditor satisfies the first qualification that it "operates predominantly in rural or underserved areas." These proposed provisions are discussed in greater detail below.

43(f)(1) Exception

43(f)(1)(i) Criteria for a Qualified Mortgage

Proposed § 226.43(f)(1)(i) implements TILA Section 129C(b)(2)(E)(i) by providing that a balloon-payment qualified mortgage must meet all of the criteria for a qualified mortgage except those requiring that the loan (1) not provide for deferral of principal repayment, (2) not provide for a balloon payment, and (3) be underwritten based on a fully amortizing payment schedule that takes into account all mortgage-related obligations and using the maximum interest rate that may apply during the first five years after consummation. Proposed comment 43(f)(1)(i)–1 clarifies that a balloon-payment qualified mortgage under this exception therefore must provide for regular periodic payments that do not result in an increase of the principal balance as required by § 226.43(e)(2)(i)(A), must have a loan term that does not exceed 30 years as required by § 226.43(e)(2)(ii), must have total points and fees that do not exceed specified thresholds pursuant to § 226.43(e)(2)(iii), and must satisfy the consideration and verification requirements in § 226.43(e)(2)(v).

Under this provision, in accordance with the statutory provisions, the exception would excuse balloon-payment qualified mortgages from the requirement in proposed § 226.43(e)(2)(i)(B) that a qualified mortgage not allow the consumer to defer repayment of principal. As noted above, deferred principal repayment may occur if the payment is applied to both accrued interest and principal but the consumer makes periodic payments that are less than the amount that would be required under a payment schedule that has substantially equal payments that fully repay the loan amount over the loan term. The scheduled payments that fully repay a balloon-payment loan over the loan term include the balloon payment itself and, therefore, are not substantially equal. Thus, balloon-payment loans permit the consumer to defer repayment of principal. The Board believes that Congress excused balloon-payment qualified mortgages from the restriction on principal repayment deferral for this reason. That rationale, however, does not necessarily extend to loans that permit principal repayment deferral by providing for interest-only payments. The Board solicits comment on whether the exception should provide that balloon-payment qualified mortgages may permit only principal repayment deferral resulting from the use of an amortization period that exceeds the loan term, as balloon-payment loans commonly do, but may not permit principal repayment deferral resulting from interest-only payments.

43(f)(1)(ii) Underwriting Using Scheduled Payments

Proposed § 226.43(f)(1)(ii) implements TILA Section 129C(b)(2)(E)(ii) by providing that, to make a balloon-payment qualified mortgage, a creditor must determine that the consumer can make all of the scheduled payments under the terms of the legal obligation, except the balloon payment, from the consumer's current or reasonably expected income or assets other than the dwelling that secures the loan. Proposed comment 43(f)(1)(ii)–1 provides the following example to illustrate the calculation of the monthly payment on which this determination must be based: Assume a loan in an amount of $200,000 that has a five-year loan term, but is amortized over 30 years. The loan agreement provides for a fixed interest rate of 6%. The loan consummates on March 15, 2011, and the monthly payment of principal and interest scheduled for the first five years is $1,199, with the first monthly payment due on May 1, 2011. The balloon payment of $187,308 is required on the due date of the 60th monthly payment, which is April 1, 2016. The loan remains a qualified mortgage if the creditor underwrites the loan using the scheduled principal and interest payment of $1,199 (plus all mortgage-related obligations, pursuant to § 226.43(f)(1)(iii)(B)).

Proposed comment 43(f)(1)(ii)–2 provides additional clarification on how a creditor may make the required determination that the consumer is able to make all scheduled payments other than the balloon payment. It states that a creditor must determine that the consumer is able to make all scheduled payments other than the balloon payment to satisfy § 226.43(f)(1)(ii), but the creditor is not required to meet the repayment ability requirements of § 226.43(c)(2)–(7) because those requirements apply only to covered transactions that are not qualified mortgages. Nevertheless, a creditor satisfies § 226.43(f)(1)(ii) if it complies with the requirements of § 226.43(c)(2)–(7). A creditor also may make the determination that the consumer is able to make the scheduled payments (other than the balloon payment) by other means. For example, a creditor need not determine that the consumer is able to make the scheduled payments based on a payment amount that is calculated in accordance with § 226.43(c)(5)(ii)(A) or may choose to consider a debt-to-income ratio that is not determined in accordance with § 226.43(c)(7).

43(f)(1)(iii) Calculation of Scheduled Payments

TILA Section 129C(b)(2)(E)(iii) provides that a balloon-payment qualified mortgage must be underwritten based on a payment schedule that fully amortizes the loan over a period of not more than 30 years and takes into account all applicable taxes, insurance, and assessments. To implement this provision, proposed § 226.43(f)(1)(iii) requires that the scheduled payments on which the determination required by § 226.43(f)(1)(ii) is based are calculated using an amortization period that does not exceed 30 years and include all mortgage-related obligations. The Board believes that the underwriting referenced in TILA Section 129C(b)(2)(E)(iii) corresponds to the determination of the consumer's repayment ability referenced in TILA Section 129C(b)(2)(E)(ii).

Further, the Board believes that the statutory reference to "a payment schedule that fully amortizes the loan over a period of not more than 30 years" refers to the amortization period used to determine the scheduled periodic payments (other than the balloon payment) under the legal obligation and not to the actual loan term of the obligation, which often is considerably shorter for a balloon-payment loan. Proposed comment 43(f)(1)(iii)–1 clarifies that balloon payments often result when the periodic payment would fully repay the loan amount only if made over some period that is longer than the loan term. The Board believes this type of transaction was the reason for the statutory exception for certain balloon-payment loans.

43(f)(1)(iv) Loan Term

As noted above, the Board is proposing to add a condition for a balloon-payment qualified mortgage that is not established by TILA Section 129C(b)(2)(E). Proposed § 226.43(f)(1)(iv) provides that a balloon-payment qualified mortgage must have a loan term of five years or longer. The Board makes this proposal pursuant to TILA Section 129C(b)(3)(B)(i), which authorizes the Board "to revise, add to, or subtract from the criteria that define a qualified mortgage upon a finding that such regulations are necessary or proper to ensure that responsible, affordable mortgage credit remains available to consumers in a manner consistent with the purposes of this section, necessary and appropriate to effectuate the purposes of this section and Section 129B, to prevent circumvention or evasion thereof, or to facilitate compliance with such sections." The purpose of TILA Section 129C is to ensure that consumers are offered and receive loans on terms that they are reasonably able to repay. TILA Section 129B(a)(2). The Board believes that a minimum loan term for balloon-payment loans is necessary and appropriate both to effectuate the purposes of TILA Section 129C and to prevent circumvention or evasion thereof.

The Board believes that the exception should be structured to prevent balloon-payment loans with very short loan terms from being qualified mortgages because such loans would present certain risks to consumers. A consumer with a loan term of less than five years, particularly where the amortization period is especially long, would face a balloon payment soon after consummation, in an amount virtually equal to the original loan amount. The consumer would establish little equity in the property under such terms, and if the pattern is repeated the consumer may never make any significant progress toward owning the home unencumbered. Thus, the greater the difference between a balloon-payment loan's amortization period and its loan term, the more likely the consumer would face this problem. The Board's proposal to require a minimum term therefore complements the 30-year maximum amortization period prescribed by TILA Section 129C(b)(2)(E)(iii).

In addition, the Board believes that some consumers may obtain balloon-payment loans as a temporary solution when they cannot afford a longer-term, fully amortizing loan. That is, because the interest rate is likely to be lower on a shorter-term obligation, a consumer may use a balloon-payment loan for more affordable financing currently, intending to refinance into a longer-term, fully amortizing loan once either the consumer's financial condition has improved or current market rates have become more favorable, or both. The Board believes that the proposed five-year minimum loan term would help ensure that qualified mortgages with balloon payments provide consumers an adequate time window in which to refinance into longer-term loans. Thus, the Board believes that the purpose of ensuring that consumers are offered and receive affordable loan terms would be served by requiring that balloon-payment qualified mortgages have a minimum loan term of five years.

The Board notes that the statute requires underwriting for an adjustable-rate qualified mortgage to be based on the maximum interest rate permitted during the first five years. TILA Section 129C(b)(2)(A)(v). Therefore, proposed § 226.43(f)(1)(iv) reflects the statutory intent that five years is a reasonable period to repay a loan.

For the foregoing reasons, the Board believes that proposed § 226.43(f)(1)(iv), in limiting the exception for balloon-payment qualified mortgages to covered transactions with loan terms of at least five years and thus ensuring that such products truly support mortgage affordability, would effectuate the purposes of TILA Section 129C and prevent circumvention or evasion thereof. The Board solicits comment on the appropriateness of this proposed additional condition as well as on the proposed use of five years as the minimum loan term.

43(f)(1)(v) Creditor Qualifications

TILA Section 129C(b)(2)(E)(iv) includes among the conditions for a balloon-payment qualified mortgage that the creditor (1) operates predominantly in rural or underserved areas; (2) together with all affiliates, has total annual residential mortgage loan originations that do not exceed a limit set by the Board; (3) retains the balloon-payment loans in portfolio; and (4) meets any asset-size threshold and any other criteria as the Board may establish. These four creditor qualifications are similar to the conditions for an exemption from the requirement that an escrow account be established for certain mortgages set forth in TILA Section 129D(c), as enacted by Section 1461 of the Dodd-Frank Act. The Board proposed to implement the escrow exemption in the 2011 Escrow Proposal. The provisions of proposed § 226.43(f)(1)(v), which implement TILA Section 129C(b)(2)(E)(iv), differ in some respects from the provisions of proposed § 226.45(b)(2)(iii) in the 2011 Escrow Proposal because of differences in the rationales underlying the two exceptions.

Proposed § 226.43(f)(1)(v) implements TILA Section 129C(b)(2)(E)(iv) by providing that a balloon-payment loan may be a qualified mortgage if the creditor (1) makes most of its balloon-payment loans in counties designated by the Board as "rural or underserved," (2) together with all affiliates extended only limited covered transactions, (3) has not sold, assigned, or otherwise transferred ownership of its balloon-payment loans, and (4) has total assets that do not exceed a threshold established and published annually by the Board, based on the year-to-year change in the average of the Consumer Price Index for Urban Wage Earners and Clerical Workers. These qualifications are discussed in more detail in the following parts of this section-by-section analysis.

"Operates Predominantly in Rural or Underserved Areas"

Under TILA Section 129C(b)(2)(E)(iv)(I), to qualify for the exception, a creditor must "operate predominantly in rural or underserved areas." To implement this provision, proposed § 226.43(f)(1)(v)(A) provides that, during the preceding calendar year, a creditor must have made more than 50% of its total balloon-payment loans in counties designated by the Board as "rural or underserved." Proposed comment 43(f)(1)(v)–1.i states that the Board publishes annually a list of counties that qualify as "rural" or "underserved." The Board's annual determinations would be based on the criteria set forth in proposed § 226.43(f)(2), discussed below.

"*Areas.*" In determining what is a rural or underserved area, the Board is proposing to use counties as the relevant area. The Board believes that the county level is the most appropriate area for this purpose, even though the sizes of counties can vary. In determining the relevant area for consumers who are shopping for mortgage loans, census tracts would be too small, while states generally would be too large. Because a single standard nationwide would facilitate compliance, the Board is proposing to use counties for all geographic areas. The Board seeks comment on the appropriateness of this approach.

"*Operates predominantly.*" As noted, the proposed rule requires a creditor to have made during the preceding calendar year more than 50% of its total balloon-payment loans in "rural or underserved" counties. The Board believes that "predominantly" indicates a portion greater than half, hence the proposed regulatory requirement of more than 50%. The Board proposes to implement "operates" consistently with the scope of the relevant qualified mortgage provision. Thus, because the definition of qualified mortgage generally excludes balloon-payment loans, *see* proposed § 226.43(e)(2)(i)(C), only those loans would be counted toward this element of the exception. The Board solicits comment on the appropriateness of both of these proposed approaches to implementing the phrase, "operates predominantly."

Total Annual Residential Mortgage Loan Originations

Under TILA Section 129C(b)(2)(E)(iv)(II), to qualify for the exception, the creditor and all affiliates together must have total annual residential mortgage loan originations that do not exceed a limit set by the Board. The Board has identified two primary issues presented in implementing this provision: (1) Whether total annual originations should be measured by number of loans or by aggregate dollar volume; and (2) the appropriate threshold under either measure.

The Board has only limited information on which to base the foregoing determinations. Thrift Financial Reports provide limited data concerning thrifts' balloon-payment loan originations; other types of depository institutions do not identify which of their mortgage originations are balloon-payment loans. Moreover, the balloon-payment loans reported by thrifts include some unknown number of commercial-purpose loans, which would not be subject to Regulation Z. Based on the limited thrift data available from 2009, the Board estimates that a threshold of $100 million in annual aggregate loan amounts originated would make approximately two-thirds of all thrifts eligible for the exception (assuming they also meet the other qualifications), and those thrifts are responsible for approximately 10% of all thrift-originated balloon-payment loans. Thus, at least among thrifts, the vast majority of balloon-payment loans are made by a minority of creditors with relatively large overall mortgage origination volumes. It is not clear, however, that 10% is the correct percentage of all balloon-payment loans to be eligible for the exception.

In light of these uncertainties, the Board is not proposing a specific threshold. To implement TILA Section 129C(b)(2)(E)(iv)(II), the Board is proposing two alternative versions of § 226.43(f)(1)(v)(B). Alternative 1 would require that, during the preceding calendar year, the creditor together with all affiliates have extended covered transactions with principal amounts that in the aggregate total a to-be-determined dollar amount or less. Alternative 2 would require that, during the preceding calendar year, the creditor together with all affiliates have extended a to-be-determined number of covered transactions or fewer. The Board is soliciting comment on both which alternative is more appropriate and the correct dollar amount or number of loans, as applicable. For example, should the threshold be 100 loans per year, something greater, or something less? Alternatively, should the threshold be $100 million in aggregate covered-transaction loan amounts per year, something greater, or something less? The Board also requests that commenters explain their rationales for any suggested thresholds. In particular, how would a specific threshold correlate with the size and scope of activity of creditors that, in the absence of the exception, would be likely to cease offering balloon-payment loans and consequently leave consumers in their markets with limited access to responsible, affordable mortgage credit? The Board also requests that commenters share any data on which their recommendations are based.

Retention of Balloon-Payment Loans in Portfolio

Under TILA Section 129C(b)(2)(E)(iv)(III), to qualify for the exception, the creditor must "retain[] the balloon loans in portfolio." Read as literally as possible, this requirement would apply to all balloon-payment loans ever made by the creditor, even those made prior to the enactment of the statute. The Board believes, however, that very few creditors, if any, would be eligible for the exception under such a reading. Therefore, the Board is proposing two alternative versions of § 226.43(f)(1)(v)(C) to implement this provision, both of which would require that the creditor not have sold, assigned, or otherwise transferred legal title to the debt obligation for any balloon-payment loan. The difference between the two alternatives lies entirely in the period during which any such transfer may not occur.

Alternative 1 would provide that the creditor must not sell any balloon-payment loan on or after the effective date of the final rule made pursuant to this proposal. This approach would implement the statute's language requiring that the creditor "retain[] the balloon loans in portfolio." The Board recognizes, however, that even this approach may be unduly limited as a practical matter; once a creditor sold even one balloon-payment loan after the effective date, it would become permanently ineligible for the exception. By contrast, Alternative 2 would limit the period during which the creditor must not have sold any balloon-payment loan to the preceding and current calendar years.

The Board solicits comment on the relative merits of Alternatives 1 and 2. The Board also seeks comment on whether, under either alternative, some *de minimis* number of transfers that may be made without losing eligibility for the exception, such as two per calendar year, would be appropriate. Finally, the Board seeks comment on whether there are any other situations in which creditors should be permitted to transfer balloon-payment loans without becoming ineligible for the exception, such as troubled institutions that need to raise capital by selling assets or institutions that enter into mergers or acquisitions.

Asset-Size Threshold

Under TILA Section 129C(b)(2)(E)(iv)(IV), to qualify for the exception, a creditor must meet any asset-size threshold established by the Board. Accordingly, proposed § 226.43(f)(1)(v)(D) requires the creditor to have total assets as of December 31 of the preceding calendar year that do not exceed an asset threshold established and published annually by the Board. The threshold dollar amount would be adjusted annually based on the year-to-year change in the average of the Consumer Price Index for Urban Wage Earners and Clerical Workers, not seasonally adjusted, for each 12-month period ending in November, with rounding to the nearest million dollars. Comment 43(f)(1)(v)–1.iv would be updated each December to publish the applicable threshold for the following calendar year. The comment would clarify that creditors that had total assets at or below the threshold on December 31 of the preceding year satisfy this criterion for purposes of the exception during the current calendar year.

This proposal would set the threshold for calendar year 2011 at $2 billion. Thus, a creditor would satisfy this element of the test if it had total assets of $2 billion or less on December 31, 2010. This number is based on the limited data available to the Board through Thrift Financial Reports, noted above, and information from commercial banks' Consolidated Reports of Condition and Income. Because of the limited information available on originations of balloon-payment loans, the Board cannot identify which creditors make more than 50% of such loans in "rural" or "underserved" counties. The Board can identify, however, the institutions that likely conduct the majority of their overall business in such locations by reference to their office locations and to the origins of their deposits. The Board believes that the locations in which creditors have offices and from which they draw their deposits likely correlate with the locations in which they extend balloon-payment loans. Of those institutions that either have over 50% of their office locations in or derive over 50% of their deposits from "rural" or "underserved" counties (under the proposed definitions of those terms, discussed below), none had total assets as of the end of 2009 greater than $2 billion.

The Board believes that Congress's intent in authorizing the Board to establish an asset-size test is to ensure that only smaller institutions that serve areas with otherwise limited credit options may qualify for the exception. At the same time, the Board believes that the asset-size test should not exclude creditors that otherwise probably are the type of community bank for which the exception is intended, *i.e.,* those engaged primarily in serving rural or underserved areas. Accordingly, the Board is proposing to set the asset-size threshold at the highest level currently held by any of the institutions that appear to meet that description. The annual adjustment to the threshold would ensure that institutions growing at a pace consistent with inflation continue to be eligible for the exception. If an institution should grow substantially beyond the rate of inflation, however, it would effectively "outgrow" the exception, consistent with Congress's intent to restrict the exception to relatively small creditors. The Board seeks comment on the appropriateness of the proposed $2 billion asset-size threshold and of the proposed annual adjustments thereto.

TILA Section 129C(b)(2)(E)(iv)(IV) authorizes but does not require an asset-size test. The Board recognizes that the other qualifications that a creditor must satisfy, discussed above, likely would be satisfied only by relatively small creditors. Thus, there may be no need for a separate asset-size test, and the exception may be as readily implemented with lesser burden to creditors by omitting such a test. Moreover, in the parallel provisions of the 2011 Escrow Proposal, the Board proposed no asset-size test on the belief that it would be unnecessary. Accordingly, the Board seeks comment on whether an asset-size test is necessary to this exception. The Board also seeks comment on what threshold is appropriate, and why, if an asset-size test is necessary. The Board requests that commenters provide any data they have underlying their recommendations on these questions.

43(f)(2) "Rural" and "Underserved" Defined

Proposed § 226.43(f)(2) sets out the criteria for a county to be designated by the Board as "rural or underserved" for purposes of proposed § 226.43(f)(1)(v)(A), discussed above. Under that section, a creditor's balloon-payment loan originations in all counties designated as "rural or underserved" during a calendar year are measured as a percentage of the creditor's total balloon-payment loan originations during that calendar year to determine whether the creditor may be eligible for the exemption during the following calendar year. If the creditor's balloon-payment loan originations in "rural or underserved" counties during a calendar year exceeded 50% of the creditor's total balloon-payment loan originations in that calendar year, the creditor would satisfy § 226.43(f)(1)(v)(A) for purposes of the following calendar year.

Proposed § 226.43(f)(2) establishes separate criteria for both "rural" and "underserved," thus a county could qualify for designation by the Board under either definition. Under proposed § 226.43(f)(2)(i), a county is designated as "rural" during a calendar year if it is not in a metropolitan statistical area or a micropolitan statistical area, as those terms are defined by the U.S. Office of Management and Budget, and either (1) it is not adjacent to any metropolitan or micropolitan area; or (2) it is adjacent to a metropolitan area with fewer than one million residents or adjacent to a micropolitan area, and it contains no town with 2,500 or more residents. Under proposed § 226.43(f)(2)(ii), a county is designated as "underserved" during a calendar year if no more than two creditors extend covered transactions five or more times in that county.

These two definitions, discussed in more detail below, parallel the definitions of the same terms as they are used in proposed § 226.45(b)(2)(iv) as set forth in the Board's 2011 Escrow Proposal. *See* proposed § 226.45(b)(2)(iv), 76 FR 11598, 11621; March 2, 2011. Both sets of proposed regulatory definitions are for purposes of implementing identical statutory provisions, thus the Board believes consistent definitions are appropriate. *See* TILA Sections 129C(b)(2)(E)(iv)(I) and 129D(c)(1) ("operates predominantly in rural or underserved areas").

"Rural"

The Board is proposing to limit the definition of "rural" areas to those areas most likely to have only limited sources of mortgage credit because of their remoteness from urban centers and their resources. The test for "rural" in proposed § 226.43(f)(2)(i), described above, is based on the "urban influence codes" numbered 7, 10, 11, and 12, maintained by the Economic Research Service (ERS) of the United States Department of Agriculture. The ERS devised the urban influence codes to reflect such factors as counties' relative population sizes, degrees of "urbanization," access to larger communities, and commuting patterns.[85] The four codes captured in the proposed "rural" definition represent the most remote rural areas, where ready access to the resources of larger, more urban communities and mobility are most limited. Proposed comment 43(f)(2)–1 states that the Board classifies a county as "rural" if it is categorized under ERS urban influence code 7, 10, 11, or 12. The Board seeks comment on all aspects of this approach to designating "rural" counties, including whether the definition should be broader or narrower, as well as whether the designation should be based on information other than the ERS urban influence codes.

"Underserved"

In determining what areas should be considered "underserved," the Board has considered the minimum number of creditors that must be engaged in significant mortgage operations in an area for consumers to have meaningful access to mortgage credit. The test for "underserved" in proposed § 226.43(f)(2)(ii), described above, is based on the Board's judgment that, where no more than two creditors are significantly active (measured by extending mortgage credit at least five times in a year), the unwillingness of one creditor to offer a balloon-payment loan would be detrimental to consumers with otherwise limited credit options. Thus, proposed § 226.43(f)(2)(ii) designates a county as "underserved" during a calendar year if no more than two creditors extend covered transactions five or more times in that county. Proposed comment 43(f)(2)–1 states that the Board bases its determinations of whether counties are "underserved" for purposes of § 226.43(f)(1)(v)(A) by reference to data submitted by mortgage lenders under the Home Mortgage Disclosure Act (HMDA).

The Board believes the purpose of the exception is to permit creditors that rely on certain balloon-payment loan products to continue to offer credit to consumers, rather than leave the mortgage loan market, if such creditors' withdrawal would significantly limit consumers' ability to obtain mortgage credit. In light of this rationale, the Board believes that "underserved" should be implemented in a way that protects consumers from losing meaningful access to mortgage credit. The Board is proposing to do so by designating as "underserved" only those areas where the withdrawal of a creditor from the market could leave no meaningful competition for consumers' mortgage business. The Board seeks comment on the appropriateness of both the proposed use of two or fewer

[85] *See http://www.ers.usda.gov/briefing/Rurality/UrbanInf/.*

existing competitors to delineate areas that are "underserved" and the proposed use of five or more covered transaction originations to identify competitors with a significant presence in a market.

43(g) Prepayment Penalties

Proposed § 226.43(g) would implement TILA Section 129C(c), which establishes certain limits on prepayment penalties for covered transactions. Specifically, TILA Section 129C(c) provides that:

- Only a covered transaction that is a qualified mortgage may contain a prepayment penalty;
- A qualified mortgage with a prepayment penalty may not have an adjustable rate and may not have an annual percentage rate that exceeds the threshold for a higher-priced mortgage loan;
- The prepayment penalty may not exceed three percent of the outstanding balance during the first year after consummation, two percent during the second year after consummation, and one percent during the third year after consummation;
- There can be no prepayment penalty after the end of the third year after consummation; and
- A creditor may not offer a consumer a loan with a prepayment penalty without offering the consumer a loan that does not include a prepayment penalty.[86]

The Board's proposal to implement TILA Section 129C(c) is discussed in detail below. The Board at this time does not propose to implement limitations on prepayment penalties the Dodd-Frank Act adds under other TILA provisions, also discussed below.

Limitations for higher-priced mortgage loans. Currently, § 226.35(b)(2) prohibits a prepayment penalty for higher-priced mortgage loans, unless certain conditions are met. In particular, the prepayment penalty must not apply after the two-year period following consummation, and the amount of the periodic payment of principal and interest or both must not change during the four-year period following consummation. New TILA Section 129C(c), as added by Section 1414 of the Dodd-Frank Act, establishes limitations on prepayment penalties that apply to all covered transactions. Thus, TILA Section 129C(c) renders superfluous the limitations on prepayment penalties with higher-priced mortgage loans adopted in the Board's 2008 HOEPA Final Rule. *See* 15 U.S.C. 1639(c), (*l*); § 226.35(b)(2). The Board accordingly proposes to remove the limitations on prepayment penalties for higher-priced mortgage loans under § 226.35(b)(2) and other requirements under § 226.35, as discussed in detail above in the section-by-section analysis of proposed § 226.35.

Limitations for high-cost mortgages. Section 1432(a) of the Dodd-Frank Act prohibits prepayment penalties with high-cost mortgages by removing TILA Section 129(c)(2), which had allowed prepayment penalties with high-cost mortgages in certain circumstances. Currently, § 226.32(d)(7) implements TILA Section 129(c)(2). At this time, the Board does not propose to remove § 226.32(d)(7) because the proposal in general does not propose to implement the other revisions to the high-cost mortgage requirements under Section 1431 of the Act. Nevertheless, under the proposal, a high-cost mortgage can include a prepayment penalty only if the high-cost mortgage meets the conditions under both current § 226.32(d)(7) and proposed § 226.43(g)(1). The joint operation of those two sets of conditions significantly limits the circumstances in which a high-cost mortgage may have a prepayment penalty.[87]

Scope; reverse mortgages. Proposed § 226.43(g) implements TILA Section 129C(c), which applies to a "residential mortgage loan," that is, to a consumer credit transaction secured by a dwelling, other than an open-end credit plan or a transaction secured by a consumer's interest in a timeshare plan. *See* TILA Section 103(cc)(5). In contrast with the exclusions for open-end credit plans and transactions secured by timeshares from coverage by ability-to-repay requirements, neither the definition of "residential mortgage loan" nor the prepayment penalty provision excludes reverse mortgages or 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. *See* TILA Sections 103(cc)(5), 129C(a)(8), 129C(c). Accordingly, the prepayment penalty requirements in proposed § 226.43(g) apply to such transactions. *See* proposed § 226.43(a)(3).

A covered transaction may include a prepayment penalty only if the transaction is a qualified mortgage. *See* TILA Section 129C(c)(1)(A); *see also* proposed § 226.43(g)(1)(ii)(B). Among other limitations, a qualified mortgage may not have a prepayment penalty if the transaction provides for an increase in the principal balance. Reverse mortgages provide for interest and fees to be added to the principal balance and thus could not include a prepayment penalty. However, the Board has authority to define a category of "qualified" closed-end reverse mortgages that can include a prepayment penalty if certain other conditions are met, pursuant to authority under TILA Sections 129C(b)(2)(A)(ix) and 129C(b)(3)(B).[88] Section 129C(b)(2)(A)(ix) authorizes the Board to define a "qualified" reverse mortgage that "meets the standards for a qualified mortgage, as set by the Board in rules that are consistent with the purposes" of TILA Section 129C(b). Also, TILA Section 129C(b)(3)(B) authorizes the Board to prescribe regulations that revise, add to, or subtract from the criteria that define a qualified mortgage upon a finding that such regulations are (1) necessary or proper to ensure that responsible, affordable mortgage credit remains available to consumers in a manner consistent with the purposes of Section 129C(b), or (2) necessary and appropriate to effectuate the purposes of Sections 129B and 129C, to prevent circumvention or evasion thereof, or to facilitate compliance therewith.

The Board does not propose to exclude "qualified" reverse mortgages from the coverage of the prepayment penalty requirements, for two reasons. First, the Board does not believe that such exclusion is necessary or proper to ensure that responsible, affordable mortgage credit remains available to consumers. The overwhelming majority of reverse mortgages to date have been insured by the Federal Housing Administration, which does not allow reverse mortgages to contain prepayment penalties.[89] The Board believes that most proprietary reverse mortgages also do not contain prepayment penalties. Accordingly, the Board believes that applying prepayment penalty requirements under TILA Section 129C(c) to closed-end reverse mortgages would have little or no effect on the availability of reverse

[86] Also, TILA Section 129C(c)(2) requires weekly publication of the "average prime offer rate" used to determine if a transaction is a "higher-priced mortgage loan."

[87] In particular, the high-cost mortgage cannot be a higher-priced mortgage loan. *See* proposed § 226.43(g)(1)(ii)(C). Also, the prepayment penalty must be permitted by applicable law. *See* § 226.32(d)(7); proposed § 226.43(g)(1)(i).

[88] Open-end credit plans are excluded from the definition of "residential mortgage loan," and thus open-end reverse mortgages are not subject to the prepayment penalty requirements under TILA Section 129C(c). TILA Section 103(cc)(5).

[89] *See* Hui Shan, "Reversing the Trend: The Recent Expansion of the Reverse Mortgage Market Finance and Economics Discussion Series," Board of Governors of the Federal Reserve System, 2009–42 (2009), available at *http://www.federalreserve.gov/pubs/feds/2009/200942/200942pap.pdf.;* 24 CFR 209(a).

mortgages. Second, the Board believes that excluding "qualified" reverse mortgages from coverage of the prepayment penalty requirements is not necessary or appropriate to effectuate the purposes of TILA Section 129C, because the Board is unaware of a reason why such exclusion would "assure that consumers are offered and receive residential mortgage loans on terms that reasonably affect their ability to repay the loans and that are understandable and not unfair, deceptive, or abusive." *See* TILA Section 129B(a)(2).

Only a qualified mortgage may have a prepayment penalty, and reverse mortgages typically do not satisfy the qualified mortgage conditions. In particular, a qualified mortgage may not provide for an increase in the transaction's principal balance. *See* TILA Section 129C(b)(2)(A)(i). However, a reverse mortgage provides for interest and fees to be added to the loan balance, instead of providing for the consumer to make payments during the loan term. Also, creditors do not consider a consumer's repayment ability for a reverse mortgage because the consumer does not make payments. Thus, because the proposal does not establish special conditions for reverse mortgages to be qualified mortgages, closed-end reverse mortgages likely may not have prepayment penalties.[90] *See* TILA Section 129C(c)(1)(A).

The Board requests comment on whether special rules should be created to permit certain reverse mortgages to have prepayment penalties. In particular, the Board requests comment on how applying such conditions would be consistent with the purposes of the alternative requirements for qualified mortgages under TILA Section 129C(b). The Board also requests comment and any supporting data on the prepayment rates for reverse mortgages.

43(g)(1) When Permitted

TILA Section 129C(c)(1)(A) provides that a covered transaction must not include a penalty for paying all or part of the principal balance after consummation unless the transaction is a qualified mortgage as defined in TILA Section 129C(b)(2). TILA Section 129C(c)(1)(B) provides that, for purposes of TILA Section 129C(c), a qualified mortgage does not include a covered transaction that has an adjustable rate or a covered transaction that has an APR that exceeds the average prime offer rate for a comparable transaction, as of the date the rate is set, by a specified number of percentage points. The applicable APR threshold depends on whether a first lien or subordinate lien secures the transaction and whether or not the transaction's original principal obligation exceeds the maximum principal obligation for a loan eligible for purchase by Freddie Mac, that is, whether or not the covered transaction is a "jumbo" loan. Specifically, the APR threshold is: (1) 1.5 percentage points above the average prime offer rate, for a first-lien, non-"jumbo" loan; (2) 2.5 percentage points above the average prime offer rate, for a first-lien "jumbo" loan; and (3) 3.5 percentage points above the average prime offer rate, for a subordinate-lien loan. These thresholds also are used for purposes of escrow account requirements for "higher-priced mortgage loans," as discussed in the 2011 Escrow Proposal.[91] Proposed § 226.43(g)(1) would implement TILA Section 129C(c)(1) and provides that a covered transaction may not include a prepayment penalty unless the prepayment penalty is otherwise permitted by law, and the transaction: (1) Has an APR that cannot increase after consummation; (2) is a qualified mortgage, as defined in proposed § 226.43(e) or (f); and (3) is not a higher-priced mortgage loan, as defined in proposed § 226.45(a).

43(g)(1)(i) Permitted by Applicable Law

Under proposed § 226.43(g)(1)(i), a prepayment penalty must be otherwise permitted by applicable law. The Board believes that TILA Section 129C(c) limits, but does not specifically authorize, including a prepayment penalty with a covered transaction. That is, TILA Section 129C(c) does not override other applicable laws, such as state laws, that may be more restrictive. Thus, a prepayment penalty would not be permitted if otherwise prohibited by applicable law. This approach is consistent with prepayment penalty requirements for high-cost mortgages and higher-priced mortgage loans. *See* § 226.32(d)(7)(i), 226.35(b)(2)(i).

43(g)(1)(ii) Transaction Conditions

43(g)(1)(ii)(A) APR Cannot Increase After Consummation

TILA Section 129C(c)(1)(B)(i) provides that a covered transaction may not include a prepayment penalty if the transaction has an "adjustable rate." The statute differs from the Board's 2008 HOEPA Final Rule, in which a high-cost mortgage or a higher-priced mortgage loan may not include a prepayment penalty if the periodic *payment* of principal or interest may change during the first four years after consummation. *See* § 226.32(d)(7)(iv), 226.35(b)(2)(C). TILA Section 129C(c)(1)(B)(i) does not specify whether the term "adjustable rate" refers to the transaction's interest rate or annual percentage rate. Rules under Regulation Z for closed-end transactions generally categorize transactions based on the possibility of APR changes rather than interest rate changes.[92] This distinction is relevant because covered transactions may have an APR that cannot increase after consummation even though the interest rate or payments may increase after consummation. For example, the APR for a "step-rate mortgage" without a variable rate feature does not change after consummation, because the rates that will apply and the periods for which they will apply are known at consummation. *Cf.* § 226.18(s)(7)(ii) (defining "step-rate mortgage" for purposes of transaction-specific interest rate and payment disclosures).

The Board proposes to interpret the prohibition on a prepayment penalty with a covered transaction that has an "adjustable rate" in TILA Section 129C(c)(1)(B)(i) to apply to covered transactions for which the APR can increase after consummation, to facilitate creditors' compliance with the various rate-related requirements under Regulation Z. Accordingly, to implement TILA Section 129C(c)(1)(B)(i), proposed § 226.43(g)(1)(ii)(A) provides that a covered transaction cannot include a prepayment penalty unless the transaction's APR cannot increase after consummation. Thus, under the Board's proposal a fixed-rate mortgage or a step-rate mortgage may have a prepayment penalty, but an adjustable-rate mortgage may not have a prepayment penalty. *See* § 226.18(s)(7)(i)–(iii) (defining "fixed-rate mortgage," "step-rate mortgage," and "adjustable-rate mortgage"). The Board solicits comment on this approach.

43(g)(1)(ii)(B) Qualified Mortgage

Under TILA Section 129C(c)(1)(A), a covered transaction may not include a prepayment penalty unless the transaction is a qualified mortgage under TILA Section 129C(b)(2). Proposed § 226.43(g)(1)(ii)(B) would implement TILA Section 129C(c)(1)(A)

[90] Open-end credit plans are excluded from the definition of "residential mortgage loan," and thus open-end reverse mortgages are not subject to the prepayment penalty requirements under TILA Section 129C(c). TILA Section 103(cc)(5).

[91] 76 FR 11598, 11608, Mar. 2, 2011 (discussing proposed new § 226.45(a)).

[92] *See, e.g.,* § 226.18(f) (requiring disclosures regarding APR increases), 226.18(s)(7)(i)–(iii) (categorizing disclosures for purposes of interest rate and payment disclosures), 226.36(e)(2)(i)–(ii) (categorizing transactions for purposes of the safe harbor for the anti-steering requirement under § 226.36(e)(1)).

and provides that a covered transaction must not include a prepayment penalty unless the transaction is a qualified mortgage under § 226.43(e) or (f). To be a qualified mortgage, a covered transaction in general may not have a balloon payment. However, a covered transaction with a balloon payment may be a qualified mortgage if the creditor originates covered transactions primarily in "rural" or "underserved" areas, as discussed in detail above in the section-by-section analysis of § 226.43(f). Thus, there are certain situations in which a consumer could face a prepayment penalty if she attempts to refinance out of a balloon-payment qualified mortgage before the balloon payment is due. The Board solicits comment on whether it would be appropriate to use legal authority under TILA Sections 105(a) and 129B(e) to provide that a balloon-payment qualified mortgage may not have a prepayment penalty in any case.

43(g)(1)(ii)(C) Threshold for a Higher-Priced Mortgage Loan

Under TILA Section 129C(c)(1)(B), a covered transaction may not include a prepayment penalty unless the transaction's APR is below specified thresholds. Accordingly, to implement TILA Section 129C(c)(1)(B), proposed § 226.43(g)(1)(ii)(C) provides that a consummated covered transaction must not include a prepayment penalty unless the transaction is not a higher-priced mortgage loan, as defined in proposed § 226.45(a) of the 2011 Escrow Proposal.

Under the Board's 2010 Mortgage Proposal, creditors would determine whether a transaction is a higher-priced mortgage loan by comparing the transaction's "transaction coverage rate," rather than APR, to the average prime offer rate, as discussed in detail in that proposal.[93] Under the 2010 Mortgage Proposal, the transaction coverage rate is a transaction-specific rate that is used solely for coverage determinations and would not be disclosed to consumers. The creditor would calculate the transaction coverage rate based on Regulation Z's rules for calculating the APR, except the creditor would make the calculation using a modified value for the prepaid finance charge. In summary, the Board explained that using the APR as the coverage metric for requirements for higher-priced mortgage loans poses a risk of over-inclusive coverage beyond the subprime market.[94] The Board noted that the average prime offer rate is based on Freddie Mac's Primary Mortgage Market Survey® of the contract interest rates and points of loans offered to consumers with low-risk transaction terms and credit profiles. APRs, however, are based on a broader set of charges, including some third-party charges such as mortgage insurance premiums. The Board also recognized that, under the Board's 2009 Closed-End Mortgage Proposal, the APR would be based on a finance charge that includes most third-party fees in addition to points, origination fees, and any other fees the creditor retains. Thus, the 2009 Closed-End Mortgage Proposal would expand the existing difference between fees included in the APR and fees included in the average prime offer rate.

To address this concern, the Board proposed in the 2010 Mortgage Proposal to require creditors to compare the transaction coverage rate, rather than the APR, to the average prime offer rate to determine whether a transaction is covered by the protections for higher-priced mortgage loans. The Board also proposed to use the transaction coverage rate for the definition of a higher-priced mortgage loan in the 2011 Escrow Proposal.[95] Similarly, under the present proposal, creditors would determine whether a transaction is a higher-priced mortgage loan based on the transaction coverage rate rather than the APR, for purposes of the prepayment penalty restriction. The Board solicits comment on this approach.

43(g)(2) Limits on Prepayment Penalties

TILA Section 129C(c)(3) provides that a prepayment penalty may not be imposed more than three years after the covered transaction is consummated and limits the maximum amount of the prepayment penalty. Specifically, a prepayment penalty is limited to (1) three percent of the outstanding principal balance during the first year following consummation; (2) two percent during the second year following consummation; and (3) one percent during the third year following consummation.

Proposed § 226.43(g)(2) would implement and is substantially similar to TILA Section 129C(c)(3). However, under proposed § 226.43(g)(2) the maximum penalty amount is determined based on the amount of the outstanding loan balance prepaid, rather than the entire outstanding loan balance, because the requirements under TILA Section 129C(c) apply if a penalty is imposed for either partial or full prepayment. Thus, for example, if the outstanding loan balance is $100,000 when the consumer prepays $20,000 eleven months after consummation, the maximum prepayment penalty is $600 (three percent of $20,000), rather than $3,000 (three percent of $100,000). The Board proposes this adjustment pursuant to the Board's authority under TILA Section 105(a) to issue regulations with such requirements, classifications, differentiations, or other provisions, and that provide for such adjustments and exceptions for all or any class of transactions, as in the judgment of the Board are necessary and proper to effectuate the purposes of TILA, to prevent circumvention or evasion thereof, or to facilitate compliance therewith. 15 U.S.C. 1604(a). The Board believes that calculating the maximum prepayment penalty based on the amount of the outstanding loan balance that is prepaid, rather than the entire outstanding loan balance, would effectuate the purposes of TILA Section 129C(c) to facilitate partial (and full) prepayment by limiting the amount of a prepayment penalty. The Board believes it would be inconsistent with congressional intent, for example, for a consumer that makes several partial prepayments to pay a percentage of the outstanding loan balance each time. The Board also believes that the proposed adjustment would facilitate compliance, because determining the maximum prepayment penalty is simpler if the calculation is based on the amount of the outstanding balance prepaid in all cases, whether the consumer prepays in full or in part.

Proposed comment 43(g)(2)–1 clarifies that a covered transaction may include a prepayment penalty that may be imposed only during a shorter period or in a lower amount than provided in proposed § 226.43(g)(2). Proposed comment 43(g)(2)–1 provides the example of a prepayment penalty that a creditor may impose for two years after consummation that is limited to two percent of the amount prepaid.

The Board recognizes that two other sections of TILA may limit the maximum amount of the prepayment penalty. First, TILA Section 129C(b)(2)(A)(vii) indirectly limits the maximum amount of a prepayment penalty with a qualified mortgage, by limiting the maximum "points and fees" for a qualified mortgage, which include prepayment penalties, to three percent of the total loan amount. *See also* proposed § 226.43(e)(2)(iii), discussed above. The definition of "points and fees" includes the maximum

[93] *See* 74 FR 58539, 58709–58710, Sept. 24, 2010 (proposing revisions to the definition of "higher-priced mortgage loan" under § 226.35(a)).

[94] *See* 74 FR at 58660–58662.

[95] *See* 75 FR 11598, 11620, Mar. 2, 2011 (proposing a new § 226.45(a)).

prepayment penalty that may be charged, as well as any prepayment penalty incurred by the consumer if the loan refinances a previous loan made or currently held by the same creditor or an affiliate of the creditor. *See* TILA Section 103(aa)(4)(E) and proposed § 226.32(b)(1), discussed above. Thus, if a creditor wants to include the maximum three percent prepayment penalty as a term of a qualified mortgage, it generally would have to forego any other charges that are included in the definition of points and fees.

Second, TILA Section 103(aa)(1)(A)(iii) defines a "high-cost mortgage" as any loan secured by the consumer's principal dwelling in which the creditor may charge prepayment fees or penalties more than 36 months after the closing of the transaction, or in which the fees or penalties exceed, in the aggregate, more than two percent of the amount prepaid. In turn, a high-cost mortgage may not contain a prepayment penalty under TILA Section 129(c), as amended by Section 1432 of the Dodd-Frank Act. At this time, the Board is not proposing to implement these limitations on prepayment penalties. The Board nevertheless solicits comment on whether proposed § 226.43(g)(2) should incorporate the limitation of prepayment penalty amounts to two percent of the amount prepaid, as provided under TILA Section 103(aa)(1)(A)(iii), or some other threshold to account for the limitation of points and fees, including prepayment penalties, for "qualified mortgages," under TILA Section 129C(b)(2)(A)(vii) and proposed § 226.43(e)(2)(iii).

43(g)(3) Alternative Offer Required

Under TILA Section 129C(c)(4), if a creditor offers a consumer a covered transaction with a prepayment penalty, the creditor also must offer the consumer a covered transaction without a prepayment penalty. As discussed in detail below, proposed § 226.43(g)(3) would implement TILA Section 129C(c)(4) and includes additional conditions: The alternative covered transaction without a prepayment penalty must (1) have an APR that cannot increase after consummation and the same type of interest rate as the covered transaction with a prepayment penalty (that is, both must be fixed-rate mortgages or both must be step-rate mortgages); (2) have the same loan term as the covered transaction with a prepayment penalty; (3) satisfy the periodic payment conditions for qualified mortgages; and (4) satisfy the points and fees conditions for qualified mortgages. The proposed additional conditions are intended to ensure that the alternative covered transactions offered have substantially similar terms. Also, proposed § 226.43(g)(3) requires that the alternative covered transaction be a transaction for which the consumer likely qualifies.

The Board proposes these additional requirements pursuant to the Board's authority under TILA Section 105(a) to prescribe regulations that contain such additional requirements, classifications, differentiations, or other provisions, or provide for such adjustments or exceptions for all or any class of transactions, as in the judgment of the Board are necessary or proper to effectuate the purposes of TILA, to prevent circumvention or evasion thereof, or to facilitate compliance therewith. 15 U.S.C. 1604(a). The Board believes that requirements designed to ensure that the alternative covered transaction with and without a prepayment penalty are substantially similar would effectuate the purposes of TILA Section 129C(c)(4), by enabling consumers to focus on a prepayment penalty's risks and benefits without having to consider or evaluate other differences between the alternative covered transactions. For example, a consumer would compare a fixed-rate mortgage with a prepayment penalty with a fixed-rate mortgage without a prepayment penalty, not with a step-rate mortgage without a prepayment penalty. Also, the Board believes that requiring the alternative covered transaction without a prepayment penalty be one for which the consumer likely qualifies would effectuate the purposes of and prevent circumvention of TILA Section 129C(c)(4), by providing for consumers to be able to choose between options that likely are available. Finally, proposed comment 43(g)(3)–1 cross-references comment 25(a)–7, discussed above, for guidance on the requirements for retaining records as evidence of compliance with § 226.43(g)(3).

Higher-priced mortgage loans. Under the proposal, a covered transaction cannot have a prepayment penalty if the transaction is a higher-priced mortgage loan. However, the requirement to offer an alternative covered transaction without a prepayment penalty is not similarly restricted. Although the Board believes the covered transaction with a prepayment penalty and the alternative covered transaction without a prepayment penalty must be substantially similar, the Board also believes a higher-priced mortgage loan without a prepayment penalty should be a permissible alternative transaction for a non-higher-priced mortgage loan with a prepayment penalty, for two reasons. First, the Board believes TILA Section 129C(c)(4) is intended to ensure consumers have a choice whether or not to obtain a covered transaction with a prepayment penalty, not to limit the pricing of the alternative covered transaction without a prepayment penalty that the creditor must offer.

Second, the Board is concerned about the likely consequences of restricting the pricing of the required alternative covered transaction without a prepayment penalty. If the alternative covered transaction must not be a higher-priced mortgage loan, the creditor may choose not to offer the consumer a loan at all, or to offer the consumer only a higher-priced mortgage loan. For example, assume that the higher-priced mortgage loan coverage threshold for a 30-year, non-jumbo, fixed-rate covered transaction is 6.50 percent, and that the creditor charges 0.25 percentage points more in interest for a covered transaction without a prepayment penalty. Assume further that the creditor would make such a loan to a consumer in a covered transaction either (1) with a prepayment penalty and with a transaction coverage rate of 6.45 percent (Transaction A); or (2) without a prepayment penalty and with a transaction coverage rate of 6.70 percent (Transaction B). However, if offering Transaction A means the creditor must offer the consumer an alternative covered transaction without a prepayment penalty that is not a higher-priced mortgage loan, the creditor may choose not to offer the consumer a covered transaction at all. Alternatively, the creditor might elect to offer the consumer only Transaction B, which is a higher-priced mortgage loan. For the foregoing reasons, under proposed § 226.43(g)(3) if a creditor offers a covered transaction with a prepayment penalty, which may not be a higher-priced mortgage loan, the creditor may offer the consumer an alternative covered transaction without a prepayment penalty that is a higher-priced mortgage loan.

Timing of offer. Proposed § 226.43(g)(3) does not require that the creditor offer an alternative covered transaction without a prepayment penalty at or by a particular time. This is consistent with § 226.36(e)(2) and (3), which provide a safe harbor for the anti–steering requirement if a loan originator presents certain loan options to the consumer, but do not contain a timing requirement. The Board recognizes that there may be costs and benefits to this approach.

On the one hand, a timing requirement could ensure that consumers can consider an offer of an alternative covered transaction without a prepayment penalty before committing to a transaction, for example, by requiring that creditors present such an offer before the consumer pays a non–refundable fee, other than a fee for obtaining the consumer's credit history.[96] Alternatively, consumers might benefit from being offered an alternative covered transaction without a prepayment penalty later in the lending process, after the creditor has underwritten the loan and determined the terms on which it would originate an alternative covered transaction to the consumer. On the other hand, timing requirements might unduly limit creditors' flexibility to determine the terms on which they will offer a particular consumer an alternative covered transaction without a prepayment penalty. In addition, there may be operational difficulties in determining exactly when a creditor offered the alternative covered transaction (for example, when a consumer accesses options for covered loans via the Internet) and how to cure a violation if the creditor offers the required alternative after the required time.

The Board solicits comment on whether it would be appropriate to require that creditors offer the alternative covered transaction without a prepayment penalty during a specified time period, for example, before the consumer pays a non–refundable fee or at least fifteen calendar days before consummation. If a timing requirement is included for purposes of proposed § 226.43(g)(3), the Board also solicits comment on whether a timing requirement should be included under the safe harbor for the anti–steering requirement under § 226.36(e)(2) and (3), for consistency.

43(g)(3)(i) APR Cannot Increase After Consummation

Under proposed § 226.43(g)(1)(i), a covered transaction with an APR that can increase after consummation may not have a prepayment penalty. Proposed § 226.43(g)(3)(i) provides that, if a creditor offers a covered transaction with a prepayment penalty, the creditor must offer an alternative covered transaction without a prepayment penalty and with an APR that cannot increase after consummation, to ensure consumers are able to choose between substantially similar alternative transactions. *See* proposed § 226.43(g)(1)(ii)(A). Proposed § 226.43(g)(3)(i) also requires that the covered transaction with a prepayment penalty and the alternative covered transaction without a prepayment penalty have the same type of interest rate. For purposes of proposed § 226.43(g)(3)(i), the term "type of interest rate" means whether the covered transaction is a fixed–rate mortgage, as defined in § 226.18(s)(7)(iii), or a step–rate mortgage, as defined in § 226.18(s)(7)(ii).[97] Proposed comment 43(g)(3)(i)-1 clarifies that the covered transaction with a prepayment penalty and the alternative covered transaction without a prepayment penalty must either both be fixed-rate mortgages or both be step-rate mortgages.

43(g)(3)(ii) Through (iv) Criteria for a Qualified Mortgage

As discussed above, proposed § 226.43(g)(1)(ii)(A) provides that a covered transaction with a prepayment penalty must be a qualified mortgage, as defined under proposed § 226.43(e)(2) or (f). The Board also proposes to require that an alternative covered transaction offered without a prepayment penalty must meet three conditions for qualified mortgages, so that consumers may choose between alternative covered transactions that are substantially similar. Accordingly, proposed § 226.43(g)(3)(ii) through (iv) provide that an alternative covered transaction without a prepayment penalty must: (1) Have the same loan term as the covered transaction with a prepayment penalty; (2) satisfy the periodic payment conditions in § 226.43(e)(2)(i); and (3) satisfy the points and fees condition under § 226.43(e)(2)(iii), based on the information known to the creditor at the time the transaction is offered. Proposed comment 43(g)(3)(iv)-1 provides guidance for cases where a creditor offers a consumer an alternative covered transaction without a prepayment penalty under proposed § 226.43(g)(3) and knows only some of the points and fees that will be charged for the loan. For example, a creditor may not know that a consumer intends to buy single-premium credit unemployment insurance, which would be included in the points and fees for the covered transactions. Proposed comment 43(g)(3)(iv)-1 clarifies that the points and fees condition is satisfied if the creditor reasonably believes, based on the information known to the creditor at the time the offer is made, that the amount of points and fees to be charged for an alternative covered transaction without a prepayment penalty will be less than or equal to the amount of points and fees allowed for a qualified mortgage under § 226.43(e)(2)(iii).

43(g)(3)(v) Likely Qualifies

Proposed § 226.43(g)(3)(v) provides that the alternative covered transaction without a prepayment penalty must be a transaction for which the creditor has a good faith belief that the consumer likely qualifies, as determined based on the information known to the creditor at the time the creditor offers the alternative covered transaction. Proposed comment 43(g)(3)(v)-1 provides an example where the creditor has a good faith belief the consumer can afford monthly payments of up to $800. The proposed comment clarifies that, if the creditor offers the consumer a fixed-rate mortgage with a prepayment penalty for which monthly payments are $700 and an alternative covered transaction without a prepayment penalty for which monthly payments are $900, the requirements of § 226.43(g)(3)(v) are not met. Proposed comment 43(g)(3)(v)-1 also clarifies that, in making the determination the consumer likely qualifies for the alternative covered transaction, the creditor may rely on information provided by the consumer, even if the information subsequently is determined to be inaccurate. Proposed § 226.43(g)(3)(v) and proposed comment 43(g)(3)(v)-1 are substantially similar to § 226.36(e)(3)(ii), which provides a safe harbor for the anti-steering requirements if, among other things, a loan originator presents the consumer with loan options for which the consumer likely qualifies. *See also* comment 36(e)(3)-4 (providing guidance on information used to determine whether or not a consumer likely qualifies for a transaction).

43(g)(4) Offer Through a Mortgage Broker

The requirement to offer an alternative covered transaction without a prepayment penalty applies to a "creditor." *See* TILA Section 129C(c)(4). TILA Section 103(f), in relevant part, defines "creditor" to mean a person who

[96] Under the Board's 2010 Mortgage Proposal, a non–refundable fee could be imposed no earlier than three business days after a consumer receives the early disclosures that creditors must provide soon after receiving the consumer's application (within three business days). *See* 75 FR 58539, 58696–58697, Sept. 24, 2010 (proposing a new § 226.19(a)(1)(iv)).

[97] Under § 226.18(s)(7)(i)–(iii), a transaction secured by real property or a dwelling is (1) an "adjustable-rate mortgage" if the APR may increase after consummation, (2) a "step-rate mortgage" if the interest rate will change after consummation, and the rates that will apply and the periods for which they will apply are known at consummation, or (3) a "fixed-rate mortgage," if the transaction is not an adjustable-rate mortgage or a step-rate mortgage.

both (1) regularly extends consumer credit which is payable by agreement in more than four installments or for which the payment of a finance charge is or may be required, and (2) is the person to whom the debt arising from the consumer credit transaction is initially payable on the face of the evidence of indebtedness (or, if there is no such evidence of indebtedness, by agreement). 15 U.S.C. 1602(f); § 226.2(a)(17). The Board proposes special rules where a creditor offers a covered transaction with a prepayment penalty through a mortgage broker, as defined in § 226.36(a)(2), to account for operational differences in offering a covered transaction through the wholesale channel versus through the retail channel.[98] As discussed below in the section-by-section analysis of proposed § 226.43(g)(5), the Board proposes special rules for cases where a creditor in a table-funded transaction also is a "loan originator," as defined in § 226.36(a)(1), because those creditors generally present to consumers loan options offered by multiple persons that provide table-funding. The Board does not propose special rules for cases where the loan originator is the creditor's employee, because the Board believes that in such cases the employee likely can present alternative covered transactions with and without a prepayment penalty to the consumer without significant operational difficulties.

The Board believes the requirement to offer an alternative covered transaction without a prepayment penalty properly is applied to creditors and not to mortgage brokers, because creditors "offer" covered transactions, even if mortgage brokers present those offers to consumers. Further, the Board believes that if Congress had intended to apply TILA Section 129C(c)(4) to mortgage brokers, Congress explicitly would have applied that provision to "mortgage originators" in addition to creditors. TILA Section 103(cc), as added by Section 1401 of the Dodd-Frank Act, defines "mortgage originator" to mean any person who, for direct or indirect compensation or gain, or in the expectation of direct or indirect compensation of gain, takes a residential mortgage loan application, assists a consumer in obtaining or applying to obtain a residential mortgage loan, or offers or negotiates terms of a residential mortgage loan. 15 U.S.C. 1602(cc). The term "mortgage originator" is used, for example, for purposes of the anti-steering requirement added to TILA by Section 1403 of the Dodd-Frank Act. *See* TILA Section 129B(c).

The Board also believes that requiring mortgage brokers to present to consumers a creditor's alternative covered transaction without a prepayment penalty could confuse consumers if they are presented with numerous other loan options. Presenting a consumer more than four loan options for each type of transaction in which the consumer expresses an interest may not help the consumer to make a meaningful choice. When compared with other loan options a mortgage broker presents to a consumer, a creditor's covered transaction without a prepayment penalty might not have the lowest interest rate (among transactions either with or without risky features, such as a prepayment penalty) or the lowest total dollar amount of origination points or fees and discount points, and thus might not be among the loan options most important for consumers to evaluate. Also, the Board is concerned that creditors may have operational difficulties in confirming whether or not a mortgage broker has presented to the consumer the alternative covered transaction without a prepayment penalty.

Accordingly, proposed § 226.43(g)(4) provides that, if a creditor offers a covered transaction to a consumer through a mortgage broker, as defined in § 226.36(a)(2), the creditor must present to the mortgage broker an alternative covered transaction without a prepayment penalty that meets the conditions under § 226.43(g)(3). Proposed § 226.43(g)(4) also provides that the creditor must establish, by agreement, that the mortgage broker must present the consumer an alternative covered transaction without a prepayment penalty that meets the conditions under § 226.43(g)(3) offered by (1) the creditor, or (2) another creditor, if the transaction has a lower interest rate or a lower total dollar amount of origination points or fees and discount points. By providing for the presentation of a loan option with a lower interest rate or a lower total dollar amount of origination points or fees and discount points than the loan option offered by the creditor, proposed § 226.43(g)(4) facilitates compliance with proposed § 226.43(g)(3) and with the safe harbor for the anti-steering requirement in connection with a single covered transaction. *See* § 226.36(e)(3)(i).[99] Proposed § 226.43(g)(4) does not affect the conditions that a a loan originator must meet to take advantage of the safe harbor for the anti-steering requirement, however. Thus, if loan originators choose to use the safe harbor, they must present the consumer the loan option with (1) the lowest interest rate overall, (2) the loan option with the lowest interest rate without certain risky features, including a prepayment penalty, and (3) the loan option with the lowest total origination points or fees and discount points. *See* § 226.36(e)(3)(i).

Proposed comment 43(g)(4)–1 clarifies that the creditor may satisfy the requirement to present the mortgage broker such alternative covered transaction without a prepayment penalty by providing the mortgage broker a rate sheet that states the terms of such an alternative covered transaction without a prepayment penalty. Proposed comment 43(g)(4)–2 clarifies that the creditor's agreement with the mortgage broker may provide for the mortgage broker to present both the creditor's covered transaction and a covered transaction offered by another creditor with a lower interest rate or a lower total dollar amount of origination points or fees and discount points. Proposed comment 43(g)(4)–2 also cross-references comment 36(e)(3)–3 for guidance in determining which step-rate mortgage has a lower interest rate. Proposed comment 43(g)(4)–3 clarifies that a creditor's agreement with a mortgage broker for purposes of proposed § 226.43(g)(4) may be part of another agreement with the mortgage broker, for example, a compensation agreement. The proposed comment clarifies that the creditor thus need not enter into a separate agreement with the mortgage broker with respect to each covered transaction with a prepayment penalty.

The Board solicits comment on the approach proposed under § 226.43(g)(4) for offering an alternative covered transaction without a prepayment penalty through a mortgage broker. In particular, the Board solicits comment on whether additional guidance is needed regarding offers of covered transactions through mortgage brokers that use the safe harbor for the anti-

[98] For ease of discussion, the terms "mortgage broker" and "loan originator" as used in this discussion have the same meaning as under the Board's requirements for loan originator compensation. *See* § 226.36(a)(1), (2).

[99] Current § 226.36(e) provides that a loan originator for a dwelling-secured consumer credit transaction must not direct or "steer" a consumer to consummate a transaction based on the fact that the originator will receive greater compensation from the creditor in that transaction than in other transactions the originator offered or could have offered the consumer, unless the consummated transaction is in the consumer's interest.

steering requirement, under § 226.36(e)(2) and (3).

43(g)(5) Creditor That Is a Loan Originator

Proposed § 226.43(g)(5) addresses cases where a creditor does not provide the funds for a covered transaction out of its own resources but rather obtains funds from another person and, immediately after consummation, assigns the note, loan contract, or other evidence of the debt obligation to the other person. Such creditors generally present to consumers loan options offered by other persons and are loan originators subject to the anti-steering requirements under § 226.36(e). *See* § 226.36(a)(1); comment 36(a)(1)–1. Like other loan originators, such creditors may use the safe harbor for the anti-steering requirements under § 226.36(e)(2) and (3). Proposed § 226.43(g)(5) provides that, if the creditor is a loan originator, as defined in § 226.36(a)(1), and the creditor presents a consumer a covered transaction with a prepayment penalty offered by a person to which the creditor would assign the covered transaction after consummation, the creditor may present the consumer an alternative covered transaction without a prepayment penalty offered by (1) the assignee, or (2) another person, if the transaction offered by the other person has a lower interest rate or a lower total dollar amount of origination points or fees and discount points. Thus, proposed § 226.43(g)(5) provides flexibility with respect to the presentation of loan options, which facilitates compliance with proposed § 226.43(g)(3) and with the safe harbor for the anti-steering requirement in connection with the same covered transaction. *See* § 226.36(e)(3)(i). Like proposed § 226.43(g)(4), however, proposed § 226.43(g)(5) does not affect the conditions that a creditor that is a loan originator must meet to take advantage of the safe harbor for the anti-steering requirement. Accordingly, if creditors that are loan originators choose to use the safe harbor, they must present the consumer the loan option with (1) the lowest interest rate overall, (2) the loan option with the lowest interest rate without certain risky features, including a prepayment penalty, and (3) the loan option with the lowest total origination points or fees and discount points. *See* § 226.36(e)(3)(i).

Proposed comment 43(g)(5)–1 clarifies that a loan originator includes any creditor that satisfies the definition of the term but makes use of "table-funding" by a third party. *See* § 226.36(a)(1), comment 36(a)–1.i, –1.ii. Proposed comment 43(g)(5)–2 cross-references guidance in comment 36(e)(3)–3 on determining which step-rate mortgage has a lower interest rate.

43(g)(6) Applicability

Proposed § 226.43(g)(6) provides that proposed § 226.43(g) applies only if a transaction is consummated with a prepayment penalty and is not violated if (1) a covered transaction is consummated without a prepayment penalty or (2) the creditor and consumer do not consummate a covered transaction. Proposed § 226.43(g)(2) limits the period during which a prepayment penalty may be imposed and the amount of any prepayment penalty. Those limitations apply only if a covered transaction with a prepayment penalty is consummated. Proposed § 226.43(g)(3) requires creditors that offer a consumer a covered transaction with a prepayment penalty offer the consumer an alternative covered transaction without a prepayment penalty, and proposed § 226.43(g)(4) and (5) establish requirements for creditors to comply with proposed § 226.43(g)(3) if they (1) offer covered transactions with a prepayment penalty through a mortgage broker or (2) are loan originators, respectively. Where a consumer consummates a covered transaction without a prepayment penalty, it is unnecessary to require that the creditor offer the consumer an alternative covered transaction without a prepayment penalty. Further, if the creditor does not consummate a covered transaction with the consumer, the issue is irrelevant; the purpose of the requirement to offer an alternative covered transaction without a prepayment penalty is for consumers not to have to accept a covered transaction with a prepayment penalty. Accordingly, proposed § 226.43(g) applies only if the consumer consummates a covered transaction with a prepayment penalty. In particular, proposed comment 25(a)–7 clarifies that, if a creditor offers the consumer a covered transaction with a prepayment penalty but a covered transaction is consummated without a prepayment penalty or if the creditor and consumer do not consummate a covered transaction, the creditor need not maintain records that document compliance with the requirement that the creditor offer an alternative covered transaction without a prepayment penalty under proposed § 226.43(g)(2) through (5), as discussed above in the section-by-section analysis of proposed § 226.25(a).

43(h) Evasion; Open-End Credit

As discussed above, TILA Section 129C, which addresses the repayment ability requirements and qualified mortgages, applies only to residential mortgage loans. TILA Section 103(cc)(5) defines "residential mortgage loans" as excluding open-end credit plans, such as HELOCs. The Board recognizes that the exclusion of open-end credit plans could lead some creditors to attempt to evade the requirements of TILA Section 129C by structuring credit as open-end instead of closed-end. Sections 226.34(b) and 226.35(b)(4) address this risk by prohibiting structuring a transaction that does not meet the definition of "open-end credit" as a HELOC to evade the repayment ability and other requirements for high-cost mortgages and higher-priced mortgage loans. The Board proposes to extend this approach to new § 226.43, which would implement TILA Section 129C. Proposed § 226.43(h) prohibits a creditor from structuring a transaction that does not meet the definition of open-end credit in § 226.2(a)(20) as a HELOC to evade the requirements of proposed § 226.43. Proposed comment 43(h)–1 clarifies that where a loan is documented as open-end credit but the features and terms or other circumstances demonstrate that it does not meet the definition of open-end credit, the loan is subject to the rules for closed-end credit, including § 226.43. The Board proposes this provision using its authority under TILA Sections 105(a) and 129B(e) to prevent circumvention or evasion.

As noted in the **SUPPLEMENTARY INFORMATION** to the Board's 2008 HOEPA Final Rule, the Board recognizes that consumers may prefer HELOCs to closed-end home equity loans because of the added flexibility HELOCs provide them. *See* 73 FR 1697, Jan. 9, 2008. It is not the Board's intention to limit consumers' ability to choose between these two ways of structuring home equity credit. An overly broad anti-evasion rule could potentially limit consumer choices by casting doubt on the validity of legitimate open-end plans. The Board seeks comment on the extent to which the proposed anti-evasion rule could have this consequence, and solicits suggestions for a more narrowly tailored rule. For example, the primary concern would appear to be with HELOCs that are substituted for closed-end home purchase loans and refinancings, which are usually first-lien loans, rather than with HELOCs taken for home improvement or other consumer purposes. The Board seeks comment on whether it should limit an anti-evasion rule to HELOCs secured by first liens where the consumer draws down all or most of the entire line of credit immediately after the account is opened, and whether such a rule would be effective in preventing evasion.

VI. Paperwork Reduction Act

In accordance with the Paperwork Reduction Act (PRA) of 1995 (44 U.S.C. 3506; 5 CFR part 1320 Appendix A.1), the Board reviewed the proposed rule under the authority delegated to the Board by the Office of Management and Budget. The rule contains no collections of information under the PRA. *See* 44 U.S.C. 3502(3). Accordingly, there is no paperwork burden associated with the rule.

VII. Initial Regulatory Flexibility Analysis

In accordance with Section 3(a) of the Regulatory Flexibility Act (RFA), 5 U.S.C. 601–612, the Board is publishing an initial regulatory flexibility analysis for the proposed amendments to Regulation Z. The RFA requires an agency either to provide an initial regulatory flexibility analysis with a proposed rule or to certify that the proposed rule will not have a significant economic impact on a substantial number of small entities. Under regulations issued by the Small Business Administration (SBA), an entity is considered "small" if it has $175 million or less in assets for banks and other depository institutions, and $7 million or less in revenues for non-bank mortgage lenders and loan servicers.[100]

Based on its analysis and for the reasons stated below, the Board believes that this proposed rule will have a significant economic impact on a substantial number of small entities. A final regulatory flexibility analysis will be conducted after consideration of comments received during the public comment period. The Board requests public comment in the following areas.

A. Reasons for the Proposed Rule

Congress enacted TILA based on findings that economic stability would be enhanced and competition among consumer credit providers would be strengthened by the informed use of credit resulting from consumers' awareness of the cost of credit. As a result, TILA contains procedural and substantive protections for consumers, and also directs the Board to prescribe regulations to carry out the purposes of the statute. TILA is implemented by the Board's Regulation Z.

The proposed amendments to Regulation Z implement certain amendments to TILA as a result of the Dodd-Frank Act. Sections 1411 and 1412 of the Dodd-Frank Act amend TILA to prohibit a creditor from making any "residential mortgage loan"[101] unless the creditor makes a reasonable and good faith determination that the consumer has a reasonable ability to repay the loan. A creditor complies with this requirement by: (i) Making a residential mortgage loan that satisfies the ability-to-repay provisions, which include certain underwriting criteria; (ii) refinancing a "non-standard mortgage" into a "standard mortgage"; (iii) making a "qualified mortgage," which is defined by prohibiting certain terms, limiting certain costs, and using certain underwriting criteria; or (iv) making a balloon-payment qualified mortgage. In addition, Section 1414 of the Dodd-Frank Act amends TILA to add new restrictions on prepayment penalties that may be imposed on residential mortgage loans.

B. Statement of Objectives and Legal Basis

The SUPPLEMENTARY INFORMATION contains the statement of objectives and legal basis for the proposed rule. In summary, the proposed amendments to Regulation Z are designed to: (1) Add new § 226.43(a)–(f) to require creditors to determine a consumer's repayment ability prior to making any residential mortgage loan; (2) provide a presumption of compliance with the repayment ability requirement or safe harbor from the repayment ability requirement for qualified mortgages in new § 226.43(e); (3) add new § 226.43(g) regarding prepayment penalty requirements for residential mortgage loans; and (4) provide record retention requirements in § 226.25(a) that evidence compliance with proposed § 226.43.

The legal basis for the proposed rule is in Sections 105(a), 129B(e) and 129C(b)(3)(B)(i) of TILA. 15 U.S.C. 1604(a), 1639b(e) and 1639c(b)(3)(B)(i). A more detailed discussion of the Board's rulemaking authority is set forth in part III of the SUPPLEMENTARY INFORMATION.

C. Description of Small Entities to Which the Proposed Rule Would Apply

The proposed regulations would apply to all institutions and entities that engage in originating or extending home-secured credit. The Board is not aware of a reliable source for the total number of small entities likely to be affected by the proposal, and the credit provisions of TILA and Regulation Z have broad applicability to individuals and businesses that originate and extend even small numbers of home-secured credit. *See* § 226.1(c)(1).[102] All small entities that originate or extend closed-end loans secured by a dwelling are potentially subject to at least some aspects of the proposed rule.

The Board can, however, identify through data from Reports of Condition and Income ("Call Reports") approximate numbers of small depository institutions that would be subject to the proposed rule. Based on December 2010 Call Report data, approximately 8,579 small institutions would be subject to the proposed rule. Approximately 15,217 depository institutions in the United States filed Call Report data, approximately 10,816 of which had total domestic assets of $175 million or less and thus were considered small entities for purposes of the RFA. Of 3,749 banks, 502 thrifts[103] and 6,565 credit unions that filed Call Report data and were considered small entities, 3,621 banks, 477 thrifts, and 4,481 credit unions, totaling 8,579 institutions, originated or extended mortgage credit.

The Board cannot identify with certainty the number of small non-depository institutions that would be subject to the proposed rule. Home Mortgage Disclosure Act (HMDA)[104]

[100] 13 CFR 121.201; *see also* SBA, Table of Small Business Size Standards Matched to North American Industry Classification System Codes, *available at http://www.sba.gov/sites/default/files/Size_Standards_Table.pdf.*

[101] TILA Section 103(cc) generally defines "residential mortgage loan" to mean any consumer credit transaction secured by a mortgage, deed of trust, or other equivalent consensual security interest on "a dwelling or on residential real property that includes a dwelling." The term does not include an open-end credit plan or an extension of credit relating to a timeshare plan, for purposes of the repayment ability provisions. *See* TILA Section 103(cc)(5).

[102] Regulation Z generally applies to "each individual or business that offers or extends credit when four conditions are met: (i) The credit is offered or extended to consumers; (ii) the offering or extension of credit is done regularly, (iii) the credit is subject to a finance charge or is payable by a written agreement in more than four installments, and (iv) the credit is primarily for personal, family, or household purposes." Section 226.1(c)(1).

[103] For purposes of this analysis, thrifts include savings banks, savings and loan entities, co-operative banks, and industrial banks.

[104] The 8,022 lenders (both depository institutions and mortgage companies) covered by HMDA in 2009 accounted for the majority of home lending in the United States. Under HMDA, lenders use a "loan/application register" (HMDA/LAR) to report information annually to their Federal supervisory agencies for each application and loan acted on during the calendar year. Only lenders that have offices (or, for non-depository institutions, lenders that are deemed to have offices) in

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data indicate that 870 non-depository institutions filed HMDA reports in 2009.[105] Based on the small volume of lending activity reported by these institutions, most are likely to be small.

D. Projected Reporting, Recordkeeping, and Other Compliance Requirements

The compliance requirements of the proposed rule are described in part V of the SUPPLEMENTARY INFORMATION. The effect of the proposed revisions to Regulation Z on small entities is unknown. Some small entities would be required, among other things, to modify their underwriting practices to account for the repayment ability analysis for covered transactions in order to comply with the revised rule. The precise costs to small entities of modifying their underwriting practices are difficult to predict. These costs will depend on a number of unknown factors, including, among other things, the current practices used by such entities to collect and analyze consumer income, asset, and liability information, the complexity of the terms of credit products that they offer, and the range of such product offerings. The proposed rule would provide small entities the option of offering only qualified mortgages, which will enjoy either a presumption of compliance with respect to the repayment ability requirement or a safe harbor from the repayment ability requirement, thus reducing litigation risks and costs for small entities.

The proposed rule also requires creditors to determine a consumer's repayment ability using a payment schedule based on monthly, fully-amortizing payments at the fully-indexed rate or introductory rate, whichever is greater. Under the proposed rule, special payment calculation rules apply to loans with a balloon payment, interest-only loans, and negative amortization loans. The proposed rule may therefore increase compliance costs for small entities, particularly for creditors that offer products that contain balloon payments, interest-only loans, and negative amortization loans. The precise costs to small entities of updating their processes and systems to account for these additional calculations are difficult to predict, but these costs are mitigated, in some circumstances, by the proposed presumption of compliance or safe harbor for qualified mortgages.

Under the proposed rule, creditors must retain evidence of compliance with proposed § 226.43 for three years after the consummation of a covered transaction. Currently, § 226.25(a) requires that creditors retain evidence of compliance with Regulation Z for two years after disclosures must be made or an action must be taken, though § 226.25(a) also clarifies that administrative agencies responsible for enforcing Regulation Z may require creditors to retain records for a longer period if necessary to carry out their enforcement responsibilities. While increasing the period creditors must retain certain records from two to three years would increase creditors' compliance burden, the precise costs to small entities is difficult to predict. However, the Board believes many creditors will retain such records for at least three years, in an abundance of caution, which would minimize the overall burden increase. The compliance burden is also mitigated by proposed comment 25(a)–6, which clarifies that creditors need not retain actual paper copies of the documentation used to underwrite a transaction. Furthermore, the proposal to extend the required retention period for evidence of compliance with proposed § 226.43 would not affect the retention period for other requirements under Regulation Z.

The Board believes that costs of the proposed rule as a whole will have a significant economic effect on small entities, including small mortgage creditors. The Board seeks information and comment on any costs, compliance requirements, or changes in operating procedures arising from the application of the proposed rule to small businesses.

E. Identification of Duplicative, Overlapping, or Conflicting Federal Rules Other Federal Rules

The Board has not identified any Federal rules that conflict with the proposed revisions to Regulation Z.

F. Identification of Duplicative, Overlapping, or Conflicting State Laws State Equivalents to TILA

Many states regulate consumer credit through statutory disclosure schemes similar to TILA. Under TILA Section 111, the proposed rule would not preempt such state laws except to the extent they are inconsistent with the proposal's requirements. 15 U.S.C. 1610.

The Board is also aware that some states regulate mortgage loans under ability-to-repay laws that resemble the proposed rule, and that many states regulate only high-cost or high-priced mortgage loans under ability-to-repay laws. The proposed rule would not preempt such state laws except to the extent they are inconsistent with the proposal's requirements. *Id.*

The Board seeks comment regarding any state or local statutes or regulations that would duplicate, overlap, or conflict with the proposed rule.

G. Discussion of Significant Alternatives

The steps the Board has taken to minimize the economic impact and compliance burden on small entities, including the factual, policy, and legal reasons for selecting the alternatives adopted and why each one of the other significant alternatives was not accepted, are described above in the SUPPLEMENTARY INFORMATION. The Board has provided an exception to the general provision that a qualified mortgage may not provide for a balloon payment for loans that are originated by certain small creditors and that meet specified criteria, as the Board understands that community banks originate balloon-payment loans to hedge against interest rate risk, rather than making adjustable-rate mortgages, and that community banks hold these balloon-payment loans in portfolio virtually without exception because they are not eligible for sale in the secondary market. The Board believes that this exception will decrease the economic impact of the proposed rules on small entities.

The Board welcomes comments on any significant alternatives consistent with the provisions of Sections 1411, 1412, and 1414 of the Dodd-Frank Act that would minimize the impact of the proposed regulations on small entities.

List of Subjects in 12 CFR Part 226

Advertising, Consumer protection, Federal Reserve System, Mortgages, Reporting and recordkeeping requirements, Truth in Lending.

Text of Proposed Revisions

Certain conventions have been used to highlight the proposed revisions. New language is shown inside bold arrows, and language that would be deleted in shown inside bold brackets.

Authority and Issuance

For the reasons set forth in the preamble, the Board proposes to amend Regulation Z, 12 CFR part 226, as follows:

PART 226—TRUTH IN LENDING (REGULATION Z)

1. The authority citation for part 226 is revised to read as follows:

metropolitan areas are required to report under HMDA. However, if a lender is required to report, it must report information on all of its home loan applications and loans in all locations, including non-metropolitan areas.

105 *The 2009 HMDA Data, available at http://www.ffiec.gov/hmda/default.htm.*

Authority: 12 U.S.C. 3806; 15 U.S.C. 1604, 1637(c)(5), and 1639(l); Sec. 2, Pub. L. 111–24, 123 Stat. 1734; Pub. L. 111–203, 124 Stat. 1376.

Subpart D—Miscellaneous

2. Section 226.25 is amended by revising paragraph (a) to read as follows:

§ 226.25 Record retention.

(a) *General rule.* A creditor shall retain evidence of compliance with ⟦this regulation⟧►§ 226.43 of this regulation for 3 years after consummation of a transaction covered by that section and shall retain evidence of compliance with all other sections of this regulation◄ (other than advertising requirements under §§ 226.16 and 226.24) for 2 years after the date disclosures are required to be made or action is required to be taken. The administrative agencies responsible for enforcing the regulation may require creditors under their jurisdictions to retain records for a longer period if necessary to carry out their enforcement responsibilities under section 108 of the act.

* * * * *

Subpart E—Special Rules for Certain Home Mortgage Transactions

3. Section 226.32 is amended by revising paragraph (b) to read as follows:

§ 226.32 Requirements for certain closed-end home mortgages.

* * * * *

(b) *Definitions.* For purposes of this subpart, the following definitions apply:

(1) For purposes of paragraph (a)(1)(ii) of this section, *points and fees* means:

(i) All items ►considered to be a finance charge◄ ⟦required to be disclosed⟧ under § 226.4(a) and 226.4(b), except ►—◄ ⟦interest or the time-price differential⟧

►(A) Interest or the time-price differential;

(B) Any premium or other charge for any guaranty or insurance protecting the creditor against the consumer's default or other credit loss to the extent that the premium or charge is—

(*1*) Assessed in connection with any Federal or state agency program;

(*2*) Not in excess of the amount payable under policies in effect at the time of origination under section 203(c)(2)(A) of the National Housing Act (12 U.S.C. 1709(c)(2)(A)), provided that the premium or charge is required to be refundable on a pro rata basis and the refund is automatically issued upon notification of the satisfaction of the underlying mortgage loan; or

(*3*) Payable after the loan closing.◄

(ii) All compensation paid ⟦to mortgage brokers⟧ ►directly or indirectly by a consumer or creditor to a loan originator, as defined in § 226.36(a)(1), including a loan originator that is also the creditor in a table-funded transaction;◄

(iii) All items listed in § 226.4(c)(7) (other than amounts held for future payment of taxes) ►payable at or before closing of the mortgage loan,◄ 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; and⟧

►(A) The charge is reasonable;

(B) The creditor receives no direct or indirect compensation in connection with the charge; and

(C) The charge is not paid to an affiliate of the creditor; ◄

(iv) ►Premiums or other charges payable at or before closing of the mortgage loan for any credit life, credit disability, credit unemployment, or credit property insurance, or any other life, accident, health, or loss-of-income insurance, or any payments directly or indirectly for any debt cancellation or suspension agreement or contract.◄ ⟦Premiums or other charges for credit life, accident, health, or loss-of-income insurance, or debt-cancellation coverage (whether or not the debt-cancellation coverage is insurance under applicable law) that provides for cancellation of all or part of the consumer's liability in the event of the loss of life, health, or income or in the case of accident, written in connection with the credit transaction.⟧

►(v) The maximum prepayment penalty, as defined in § 226.43(b)(10), that may be charged or collected under the terms of the mortgage loan; and

(vi) The total prepayment penalty, as defined in § 226.43(b)(10), incurred by the consumer if the mortgage loan is refinanced by the current holder of the existing mortgage loan, a servicer acting on behalf of the current holder, or an affiliate of either.

(2) For purposes of paragraph (b)(1)(ii) of this section, the term *points and fees* does not include compensation paid to—

(i) An employee of a retailer of manufactured homes who does not take a residential mortgage loan application, offer or negotiate terms of a residential mortgage loan, or advise a consumer on loan terms (including rates, fees, and other costs) but who, for compensation or other monetary gain, or in expectation of compensation or other monetary gain, assists a consumer in obtaining or applying to obtain a residential mortgage loan;

(ii) A person that only performs real estate brokerage activities and is licensed or registered in accordance with applicable state law, unless such person is compensated by a creditor or loan originator, as defined in § 226.36(a)(1), or by any agent of the creditor or loan originator; or

(iii) A servicer or servicer employees, agents and contractors, including but not limited to those who offer or negotiate terms of a covered transaction for purposes of renegotiating, modifying, replacing and subordinating principal of existing mortgages where borrowers are behind in their payments, in default or have a reasonable likelihood of being in default or falling behind.

(3)◄⟦(2)⟧ Affiliate means 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 (12 U.S.C. 1841 *et seq.*).

* * * * *

4. Section 226.34, is amended by removing paragraph (a)(4).

§ 226.34 Prohibited acts or practices in connection with credit subject to § 226.32.

(a) * * *

⟦(4) *Repayment ability.* Extend credit subject to § 226.32 to a consumer based on the value of the consumer's collateral without regard to the consumer's repayment ability as of consummation, including the consumer's current and reasonably expected income, employment, assets other than the collateral, current obligations, and mortgage-related obligations.

(i) *Mortgage-related obligations.* For purposes of this paragraph (a)(4), mortgage-related obligations are expected property taxes, premiums for mortgage-related insurance required by the creditor as set forth in § 226.35(b)(3)(i), and similar expenses.

(ii) *Verification of repayment ability.* Under this paragraph (a)(4) a creditor must verify the consumer's repayment ability as follows:

(A) A creditor must verify amounts of income or assets that it relies on to determine repayment ability, including expected income or assets, by the consumer's Internal Revenue Service Form W–2, tax returns, payroll receipts, financial institution records, or other third-party documents that provide reasonably reliable evidence of the consumer's income or assets.

(B) Notwithstanding paragraph (a)(4)(ii)(A), a creditor has not violated paragraph (a)(4)(ii) if the amounts of income and assets that the creditor relied upon in determining repayment ability are not materially greater than the amounts of the consumer's income or assets that the creditor could have verified pursuant to paragraph (a)(4)(ii)(A) at the time the loan was consummated.

(C) A creditor must verify the consumer's current obligations.

(iii) *Presumption of compliance.* A creditor is presumed to have complied with this paragraph (a)(4) with respect to a transaction if the creditor:

(A) Verifies the consumer's repayment ability as provided in paragraph (a)(4)(ii);

(B) Determines the consumer's repayment ability using the largest payment of principal and interest scheduled in the first seven years following consummation and taking into account current obligations and mortgage-related obligations as defined in paragraph (a)(4)(i); and

(C) Assesses the consumer's repayment ability taking into account at least one of the following: The ratio of total debt obligations to income, or the income the consumer will have after paying debt obligations.

(iv) *Exclusions from presumption of compliance.* Notwithstanding the previous paragraph, no presumption of compliance is available for a transaction for which:

(A) The regular periodic payments for the first seven years would cause the principal balance to increase; or

(B) The term of the loan is less than seven years and the regular periodic payments when aggregated do not fully amortize the outstanding principal balance.

(v) *Exemption.* This paragraph (a)(4) does not apply to temporary or "bridge" loans with terms of twelve months or less, such as a loan to purchase a new dwelling where the consumer plans to sell a current dwelling within twelve months.◄

* * * * *

§ 226.35 [Removed and reserved]

5. Section 226.35 is removed and reserved.

6. Add § 226.43 to read as follows:

►§ 226.43 Minimum standards for transactions secured by a dwelling.

(a) *Scope.* This section applies to any consumer credit transaction that is secured by a dwelling, as defined in § 226.2(a)(19), other than:

(1) A home equity line of credit subject to § 226.5b;

(2) A mortgage transaction secured by a consumer's interest in a timeshare plan, as defined in 11 U.S.C. 101(53(D)); or

(3) For purposes of paragraphs (c) through (f) of this section—

(i) A reverse mortgage subject to § 226.33; or

(ii) A temporary or "bridge" loan with a term of 12 months or less, such as a loan to finance the purchase of a new dwelling where the consumer plans to sell a current dwelling within 12 months or a loan to finance the initial construction of a dwelling.

(b) *Definitions.* For purposes of this section:

(1) *Covered transaction* means a consumer credit transaction that is secured by a dwelling, as defined in § 226.2(a)(19), other than a transaction exempt from coverage under paragraph (a) of this section.

(2) *Fully amortizing payment* means a periodic payment of principal and interest that will fully repay the loan amount over the loan term.

(3) *Fully indexed rate* means the interest rate calculated using the index or formula at the time of consummation and the maximum margin that can apply at any time during the loan term.

(4) *Higher-priced covered transaction* means a covered transaction with an annual percentage rate that exceeds the average prime offer rate for a comparable transaction as of the date the interest rate is set by 1.5 or more percentage points for a first-lien covered transaction, or by 3.5 or more percentage points for a subordinate-lien covered transaction.

(5) *Loan amount* means the principal amount the consumer will borrow as reflected in the promissory note or loan contract.

(6) *Loan term* means the period of time to repay the obligation in full.

(7) *Maximum loan amount* means the loan amount plus any increase in principal balance that results from negative amortization, as defined in § 226.18(s)(7)(v), based on the terms of the legal obligation assuming—

(i) The consumer makes only the minimum periodic payments for the maximum possible time, until the consumer must begin making fully amortizing payments; and

(ii) The maximum interest rate is reached at the earliest possible time.

(8) *Mortgage-related obligations* mean property taxes; mortgage-related insurance premiums required by the creditor as set forth in § 226.45(b)(1); homeowner's association, condominium, and cooperative fees; ground rent or leasehold payments; and special assessments.

(9) *Points and fees* has the same meaning as in § 226.32(b)(1).

(10) *Prepayment penalty* means a charge imposed for paying all or part of a covered transaction's principal before the date on which the principal is due. For purposes of this section—

(i) The following are examples of prepayment penalties:

(A) A charge determined by treating the loan balance as outstanding for a period of time after prepayment in full and applying the interest rate to such "balance," even if the charge results from the interest accrual amortization method used for other payments in the transaction; and

(B) A fee, such as a loan closing cost, that is waived unless the consumer prepays the covered transaction.

(ii) A prepayment penalty does not include fees imposed for preparing and providing documents when a loan is paid in full, whether or not the loan is prepaid, such as a loan payoff statement, a reconveyance document, or another document releasing the creditor's security interest in the dwelling that secures the loan.

(11) *Recast* means—

(i) For an adjustable-rate mortgage, as defined in § 226.18(s)(7)(i), the expiration of the period during which payments based on the introductory fixed interest rate are permitted under the terms of the legal obligation;

(ii) For an interest-only loan, as defined in § 226.18(s)(7)(iv), the expiration of the period during which interest-only payments are permitted under the terms of the legal obligation; and

(iii) For a negative amortization loan, as defined in § 226.18(s)(7)(v), the expiration of the period during which negatively amortizing payments are permitted under the terms of the legal obligation.

(12) *Simultaneous loan* means another covered transaction or home equity line of credit subject to § 226.5b that will be secured by the same dwelling and made to the same consumer at or before consummation of the covered transaction.

(13) *Third-party record* means—

(i) A document or other record prepared or reviewed by a person other than the consumer, the creditor, or the mortgage broker, as defined in § 226.36(a)(2), or an agent of the creditor or mortgage broker;

(ii) A copy of a tax return filed with the Internal Revenue Service or a state taxing authority;

(iii) A record the creditor maintains for an account of the consumer held by the creditor; or

(iv) If 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.

(c) *Repayment ability*—(1) *General requirement.* A creditor shall not make a loan in a covered transaction unless the creditor makes a reasonable and good faith determination at or before consummation that the consumer will have a reasonable ability, at the time of consummation, to repay the loan according to its terms, including any mortgage-related obligations.

(2) *Basis for determination.* Except as provided otherwise in paragraphs (d), (e), and (f) of this section, in making the repayment ability determination required under paragraph (c)(1) of this section, a creditor must consider the following:

(i) The consumer's current or reasonably expected income or assets, other than the value of the dwelling that secures the loan;

(ii) If the creditor relies on income from the consumer's employment in determining repayment ability, the consumer's current employment status;

(iii) The consumer's monthly payment on the covered transaction, calculated in accordance with paragraph (c)(5) of this section;

(iv) The consumer's monthly payment on any simultaneous loan that the creditor knows or has reason to know will be made, calculated in accordance with paragraph (c)(6) of this section;

(v) The consumer's monthly payment for mortgage-related obligations;

(vi) The consumer's current debt obligations;

(vii) The consumer's monthly debt-to-income ratio, or residual income in accordance with paragraph (c)(7) of this section; and

(viii) The consumer's credit history.

(3) *Verification using third-party records.* A creditor must verify a consumer's repayment ability using reasonably reliable third-party records, except that—

(i) For purposes of paragraph (c)(2)(ii) of this section, a creditor may verify a consumer's employment status orally if the creditor prepares a record of the information obtained orally; and

(ii) For purposes of paragraph (c)(2)(vi) of this section, if a creditor relies on a consumer's credit report to verify a consumer's current debt obligations and a consumer's application states a current debt obligation not shown in the consumer's credit report, the creditor need not independently verify such obligation.

(4) *Verification of income or assets.* A creditor must verify the amounts of income or assets it relies on to determine a consumer's ability to repay a covered transaction using third-party records that provide reasonably reliable evidence of the consumer's income or assets. A creditor may verify the consumer's income using a tax-return transcript issued by the Internal Revenue Service (IRS). Examples of other records the creditor may use to verify the consumer's income or assets include:

(i) Copies of tax returns the consumer filed with the Internal Revenue Service or a state taxing authority;

(ii) IRS Form W–2s or similar IRS forms used for reporting wages or tax withholding;

(iii) Payroll statements, including military Leave and Earnings Statements;

(iv) Financial institution records;

(v) Records from the consumer's employer or a third-party that obtained information from the employer;

(vi) Records from a Federal, state, or local government agency stating the consumer's income from benefits or entitlements;

(vii) Receipts from the consumer's use of check cashing services; and

(viii) Receipts from the consumer's use of a funds transfer service.

(5) *Payment calculation*—(i) *General rule.* Except as provided in paragraph (c)(5)(ii) of this section, a creditor must make the determination required under paragraph (c)(2)(iii) using—

(A) The fully indexed rate or any introductory interest rate, whichever is greater; and

(B) Monthly, fully amortizing payments that are substantially equal.

(ii) *Special rules for loans with a balloon payment, interest-only loans, and negative amortization loans.* A creditor must make the determination required under paragraph (c)(2)(iii) for—

(A) A loan with a balloon payment, as defined in § 226.18(s)(5)(i), using—

(*1*) The maximum payment scheduled during the first five years after consummation for a loan that is not a higher-priced covered transaction; or

(*2*) The maximum payment in the payment schedule, including any balloon payment, for a higher-priced covered transaction;

(B) An interest-only loan, as defined in § 226.18(s)(7)(iv), using—

(*1*) The fully indexed rate or any introductory interest rate, whichever is greater; and

(*2*) Substantially equal, monthly payments of principal and interest that will repay the loan amount over the term of the loan remaining as of the date the loan is recast.

(C) A negative amortization loan, as defined in § 226.18(s)(7), using—

(*1*) The fully indexed rate or any introductory interest rate, whichever is greater; and

(*2*) Substantially equal, monthly payments of principal and interest that will repay the maximum loan amount over the term of the loan remaining as of the date the loan is recast.

(6) *Payment calculation for simultaneous loans.* For purposes of making the determination required under paragraph (c)(2)(iv) of this section, a creditor must consider a consumer's payment on a simultaneous loan that is—

(i) A covered transaction, by following paragraphs (c)(5)(i)–(ii) of this section; or

(ii) A home equity line of credit subject to § 226.5b, by using the periodic payment required under the terms of the plan and the amount of credit drawn at consummation of the covered transaction.

(7) *Monthly debt-to-income ratio or residual income*—(i) *Definitions.* For purposes of this paragraph, the following definitions apply—

(A) *Total monthly debt obligations.* The term *total monthly debt obligations* means the sum of: the payment on the covered transaction, as required to be calculated by paragraphs (c)(2)(iii) and (c)(5) of this section; simultaneous loans, as required by paragraphs (c)(2)(iv) and (c)(6) of this section; mortgage-related obligations, as required by paragraph (c)(2)(v) of this section; and current debt obligations, as required by paragraph (c)(2)(vi) of this section.

(B) *Total monthly income.* The term *total monthly income* means the sum of the consumer's current or reasonably expected income, including any income from assets, as required paragraphs (c)(2)(i) and (c)(4) of this section.

(ii) *Calculations.* (A) *Monthly debt-to-income ratio.* For purposes of considering the consumer's monthly debt-to-income ratio under paragraph (c)(2)(vii) of this section, the creditor must consider the ratio of the consumer's total monthly debt obligations to total monthly income.

(B) *Monthly residual income.* For purposes of considering the consumer's monthly residual income under paragraph (c)(2)(vii) of this section, the creditor must consider the consumer's remaining income after subtracting the consumer's total monthly debt obligations from the total monthly income.

(d) *Refinancing of non-standard mortgages*—(1) *Scope.* The provisions of this paragraph (d) apply to the refinancing of a non-standard mortgage into a standard mortgage when the following conditions are met—

(i) The creditor for the standard mortgage is the current holder of the existing non-standard mortgage or the servicer acting on behalf of the current holder.

(ii) The monthly payment for the standard mortgage is materially lower than the monthly payment for the non-standard mortgage, as calculated under paragraph (d)(5) of this section.

(iii) The creditor receives the consumer's written application for the standard mortgage before the non-standard mortgage is recast.

(iv) The consumer has made no more than one payment more than 30 days late on the non-standard mortgage during the 24 months immediately preceding the creditor's receipt of the consumer's written application for the standard mortgage.

(v) The consumer has made no payments more than 30 days late during the six months immediately preceding the creditor's receipt of the consumer's written application for the standard mortgage.

(2) *Definitions.* For purposes of this paragraph (d), the following definitions apply:

(i) *Non-standard mortgage.* The term *non-standard mortgage* means a covered transaction that is—

(A) An adjustable-rate mortgage, as defined in § 226.18(s)(7)(i), with an introductory fixed interest rate for a period of one year or longer;

(B) An interest-only loan, as defined in § 226.18(s)(7)(iv); or

(C) A negative amortization loan, as defined in § 226.18(s)(7)(v).

(ii) *Standard mortgage.* The term *standard mortgage* means a covered transaction—

(A) That provides for regular periodic payments that do not:

(*1*) Cause the principal balance to increase;

(*2*) Allow the consumer to defer repayment of principal; or

(*3*) Result in a balloon payment, as defined in § 226.18(s)(5)(i);

(B) For which the total points and fees payable in connection with the transaction do not exceed the amounts specified in paragraph (e)(3) of this section;

(C) For which the term does not exceed 40 years;

(D) For which the interest rate is fixed for at least the first five years after consummation; and

(E) For which the proceeds from the loan are used solely for the following purposes—

(*1*) To pay off the outstanding principal balance on the non-standard mortgage; and

(*2*) To pay closing or settlement charges required to be disclosed under the Real Estate Settlement Procedures Act, 12 U.S.C. 2601 *et seq.*

(iii) *Refinancing.* The term *refinancing* has the same meaning as in § 226.20(a).

(3) *Exemption from certain repayment ability requirements.* (i) A creditor is not required to comply with the income and asset verification requirements of paragraphs (c)(2)(i) and (c)(4) of this section or the payment calculation requirements under paragraphs (c)(2)(iii) and (c)(5) of this section if—

(A) The conditions in paragraph (d)(1) of this section are met; and

(B) The creditor has considered whether the standard mortgage will prevent a likely default by the consumer on the non-standard mortgage at the time of its recast.

(ii) If the conditions in paragraph (d)(3)(i) of this section are met, the creditor shall satisfy the requirements under paragraphs (c)(2)(iii) and (c)(5) of this section for the standard mortgage by using the payment calculation prescribed under paragraph (d)(5)(ii) of this section.

(4) *Offer of rate discounts and other favorable terms.* A creditor making a covered transaction under this paragraph (d) may offer to the consumer the same or better rate discounts and terms that the creditor offers to new consumers, consistent with the creditor's documented underwriting practices and to the extent not prohibited by applicable state or Federal law.

(5) *Payment calculations.* For purposes of determining whether the consumer's monthly payment for a standard mortgage will be materially lower than the monthly payment for the non-standard mortgage, the following provisions shall be used:

(i) *Non-standard mortgage.* The monthly payment for a non-standard mortgage must be based on substantially equal, monthly, fully amortizing payments of principal and interest using—

(A) The fully indexed rate as of a reasonable period of time before or after the date on which the creditor receives the consumer's written application for the standard mortgage;

(B) The term of the loan remaining as of the date on which the recast occurs, assuming all scheduled payments have been made up to the recast date and the payment due on the recast date is made and credited as of that date; and

(C) A remaining loan amount that is—

(*1*) For an adjustable-rate mortgage under paragraph (d)(2)(i)(A) of this section, the outstanding principal balance as of the date of the recast, assuming all scheduled payments have been made up to the recast date and the payment due on the recast date is made and credited as of that date;

(*2*) For an interest-only loan under paragraph (d)(2)(i)(B) of this section, the loan amount, assuming all scheduled payments have been made up to the recast date and the payment due on the recast date is made and credited as of that date;

(*3*) For a negative amortization loan under paragraph (d)(2)(i)(C) of this section, the maximum loan amount.

(ii) *Standard mortgage.* The monthly payment for a standard mortgage must be based on substantially equal, monthly, fully amortizing payments based on the maximum interest rate that may apply during the first five years after consummation.

(e) *Qualified mortgages.*

Alternative 1—Paragraph (e)(1)

(1) *Safe harbor.* A creditor or assignee of a covered transaction complies with the repayment ability requirement of paragraph (c)(1) of this section if the covered transaction is a qualified mortgage, as defined in paragraph (e)(2) of this section.

Alternative 2—Paragraph (e)(1)

(1) *Presumption of compliance.* A creditor or assignee of a covered transaction is presumed to have complied with the repayment ability requirements of paragraph (c)(1) of this section if the covered transaction is a qualified mortgage, as defined in paragraph (e)(2) of this section.

(2) *Qualified mortgage defined.* A qualified mortgage is a covered transaction—

(i) That provides for regular periodic payments that do not—

(A) Result in an increase of the principal balance;

(B) Allow the consumer to defer repayment of principal, except as provided in paragraph (f) of this section; or

(C) Result in a balloon payment, as defined in § 226.18(s)(5)(i), except as provided in paragraph (f) of this section;

(ii) For which the loan term does not exceed 30 years;

(iii) For which the total points and fees payable in connection with the loan do not exceed the amounts specified in paragraph (e)(3) of this section;

(iv) For which the creditor underwrites the loan, taking into account any mortgage-related obligations, using—

(A) The maximum interest rate that may apply during the first five years after consummation; and

(B) Periodic payments of principal and interest that will repay either—

(*1*) The outstanding principal balance over the remaining term of the loan as of the date the interest rate adjusts to the maximum interest rate set forth in paragraph (e)(2)(iv)(A) of this section; or

(*2*) The loan amount over the loan term.

Alternative 1—Paragraph (e)(2)(v)

(v) For which the creditor considers and verifies the consumer's current or reasonably expected income or assets to determine the consumer's repayment ability, as required by paragraphs (c)(2)(i), (c)(3), and (c)(4) of this section.

Alternative 2—Paragraph (e)(2)(v)

(v) For which the creditor considers and verifies, in accordance with paragraph (c)(3) of this section, the following:

(A) The consumer's current or reasonably expected income or assets other than the value of the dwelling that secures the loan, in accordance with paragraphs (c)(2)(i) and (c)(4) of this section;

(B) If the creditor relies on income from the consumer's employment in determining repayment ability, the consumer's current employment status, in accordance with paragraph (c)(2)(ii) of this section;

(C) The consumer's monthly payment on any simultaneous loan that the creditor knows or has reason to know will be made, in accordance with paragraphs (c)(2)(iv) and (c)(6) of this section;

(D) The consumer's current debt obligations, in accordance with paragraph (c)(2)(vi) of this section;

(E) The consumer's monthly debt-to-income ratio, or residual income, in accordance with paragraphs (c)(2)(vii) and (c)(7) of this section; and

(F) The consumer's credit history, in accordance with paragraph (c)(viii) of this section.

(3) *Limits on points and fees for qualified mortgages.*

Alternative 1—Paragraph (e)(3)(i)

(i) A covered transaction is not a qualified mortgage unless the total points and fees payable in connection with the loan do not exceed—

(A) For a loan amount of $75,000 or more, three percent of the total loan amount;

(B) For a loan amount of greater than or equal to $60,000 but less than $75,000, 3.5 percent of the total loan amount;

(C) For a loan amount of greater than or equal to $40,000 but less than $60,000, four percent of the total loan amount;

(D) For a loan amount of greater than or equal to $20,000 but less than $40,000, 4.5 percent of the total loan amount; and

(E) For a loan amount of less than $20,000, five percent of the total loan amount.

Alternative 2—Paragraph (e)(3)(i)

(i) A covered transaction is not a qualified mortgage unless the total points and fees payable in connection with the loan do not exceed—

(A) For a loan amount of $75,000 or more, three percent of the total loan amount;

(B) For a loan amount of greater than or equal to $20,000 but less than $75,000, a percentage of the total loan amount resulting from the following formula—

(*1*) Total loan amount − $20,000 = $Z;

(*2*) $Z × .0036 = Y;

(*3*) 500 − Y = X; and

(*4*) X × .01 = Allowable points and fees as a percentage of the total loan amount; and

(C) For a loan amount of less than $20,000, five percent of the total loan amount.

(ii) For purposes of calculating the total amount of points and fees that are payable in connection with a covered transaction under (e)(3)(i), the following may be excluded:

(A) Any bona fide third party charge not retained by the creditor, loan originator, or an affiliate of either, unless the charge is required to be included in "points and fees" under § 226.32(b)(1)(i)(B).

(B) Up to two bona fide discount points paid by the consumer in connection with the transaction, provided that the following conditions are met—

(*1*) The interest rate before the discount does not exceed the average prime offer rate, as defined in § 226.45(a)(2)(ii), by more than one percent; and

(*2*) The average prime offer rate used for purposes of paragraph (e)(3)(ii)(B)(*1*) of this section is the same average prime offer rate that applies to a comparable transaction as of the date the discounted interest rate for the transaction is set.

(C) Up to one bona fide discount point paid by the consumer in connection with the transaction, provided that the following conditions are met—

(*1*) The interest rate before the discount does not exceed the average prime offer rate, as defined in § 226.45(a)(2)(ii), by more than two percent;

(*2*) The average prime offer rate used for purposes of paragraph (e)(3)(ii)(C)(*1*) of this section is the same average prime offer rate that applies to a comparable transaction as of the date the discounted interest rate for the transaction is set; and

(*3*) Two bona fide discount points have not been excluded under paragraph (e)(3)(ii)(B) of this section.

(iii) The term *loan originator* has the same meaning as in § 226.36(a)(1).

(iv) The term *bona fide discount point* means any percent of the loan amount of a covered transaction paid by the consumer that reduces the interest rate or time-price differential applicable to the covered transaction based on a calculation that—

(A) Is consistent with established industry practices for determining the amount of reduction in the interest rate or time-price differential appropriate for the amount of discount points paid by the consumer; and

(B) Accounts for the amount of compensation that the creditor can reasonably expect to receive from secondary market investors in return for the mortgage loan.

(f) *Balloon-payment qualified mortgages made by certain creditors*—(1) *Exception.* Notwithstanding paragraph (e)(2)(i)(C) of this section, a qualified mortgage may provide for a balloon payment, provided—

(i) The loan satisfies all of the requirements for a qualified mortgage in paragraph (e)(2) of this section, other than paragraphs (e)(2)(i)(B), (e)(2)(i)(C), and (e)(2)(iv) of this section;

(ii) The creditor determines that the consumer can make all of the scheduled payments under the terms of the legal obligation, except the balloon payment, from the consumer's current or reasonably expected income or assets other than the dwelling that secures the loan;

(iii) The scheduled payments on which the determination required by paragraph (f)(1)(ii) of this section is based:

(A) Are calculated using an amortization period that does not exceed 30 years; and

(B) Include all mortgage-related obligations;

(iv) The loan term is five years or longer; and

(v) The creditor:

(A) During the preceding calendar year, extended more than 50% of its total covered transactions that provide for balloon payments in one or more counties designated by the Board as "rural" or "underserved," as defined in paragraph (f)(2) of this section;

Alternative 1—Paragraph (f)(1)(v)(B)

(B) During the preceding calendar year, together with all affiliates, extended covered transactions with loan amounts that in the aggregate total $___ or less;

Alternative 2—Paragraph (f)(1)(v)(B)

(B) During the preceding calendar year, together with all affiliates, extended ___ or fewer covered transactions;

Alternative 1—Paragraph (f)(1)(v)(C)

(C) On or after [effective date of final rule], has not sold, assigned, or otherwise transferred legal title to the debt obligation for any covered transaction that provides for a balloon payment; and

Alternative 2—Paragraph (f)(1)(v)(C)

(C) During the preceding and current calendar year, has not sold, assigned, or otherwise transferred legal title to the debt obligation for any covered transaction that provides for a balloon payment; and

(D) As of the end of the preceding calendar year, had total assets that do not exceed the asset threshold established and published annually by the Board, based on the year-to-year change in the average of the Consumer Price Index for Urban Wage Earners and Clerical Workers, not seasonally adjusted, for each 12-month period ending in November, with rounding to the nearest million dollars. (See staff comment 43(f)(1)(v)–1.iv for the current threshold.)

(2) "*Rural*" *and* "*underserved*" *defined.* For purposes of paragraph (f)(1)(v)(A) of this section—

(i) A county is "rural" during a calendar year if it is not in a metropolitan statistical area or a micropolitan statistical area, as those terms are defined by the U.S. Office of Management and Budget, and:

(A) It is not adjacent to any metropolitan area or micropolitan area; or

(B) It is adjacent to a metropolitan area with fewer than one million residents or adjacent to a micropolitan area, and it contains no town with 2,500 or more residents.

(ii) A county is "underserved" during a calendar year if no more than two creditors extend covered transactions five or more times in the county.

(g) *Prepayment penalties*—(1) *When permitted.* A covered transaction must not include a prepayment penalty unless:

(i) The prepayment penalty is otherwise permitted by law; and

(ii) The transaction—

(A) Has an annual percentage rate that cannot increase after consummation;

(B) Is a qualified mortgage under paragraph (e)(2) or (f) of this section; and

(C) Is not a higher-priced mortgage loan, as defined in § 226.45(a).

(2) *Limits on prepayment penalties.* A prepayment penalty—

(i) Must not apply after the three-year period following consummation; and

(ii) Must not exceed the following percentages of the amount of the outstanding loan balance prepaid:

(A) Three percent, if incurred during the first year following consummation;

(B) Two percent, if incurred during the second year following consummation; and

(C) One percent, if incurred during the third year following consummation.

(3) *Alternative offer required.* Except as provided otherwise in paragraph (g)(4) or (g)(5) of this section, a creditor must not offer a consumer a covered transaction with a prepayment penalty unless the creditor also offers the consumer an alternative covered transaction without a prepayment penalty and the alternative covered transaction—

(i) Has an annual percentage rate that cannot increase after consummation and has the same type of interest rate as the covered transaction with a prepayment penalty. For purposes of this paragraph (g), the term "type of interest rate" refers to whether a transaction:

(A) Is a fixed-rate mortgage, as defined in § 226.18(s)(7)(iii); or

(B) Is a step-rate mortgage, as defined in § 226.18(s)(7)(ii).

(ii) Has the same loan term as the loan term for the covered transaction with a prepayment penalty;

(iii) Satisfies the periodic payment conditions under paragraph (e)(2)(i) of this section;

(iv) Satisfies the points and fees conditions under paragraph (e)(2)(iii) of this section, based on the information known to the creditor at the time the transaction is offered; and

(v) Is a transaction for which the creditor has a good faith belief that the consumer likely qualifies, based on the information known to the creditor at the time the creditor offers the covered transaction without a prepayment penalty.

(4) *Offer through a mortgage broker.* If the creditor offers a covered transaction with a prepayment penalty to the consumer through a mortgage broker, as defined in § 226.36(a)(2), the creditor must—

(i) Present the mortgage broker an alternative covered transaction without a prepayment penalty that satisfies the requirements of paragraph (g)(3) of this section; and

(ii) Establish by agreement that the mortgage broker must present the consumer an alternative covered transaction without a prepayment penalty that satisfies the requirements of paragraph (g)(3) of this section, offered by—

(A) The creditor; or

(B) Another creditor, if the transaction offered by the other creditor has a lower interest rate or a lower total dollar amount of origination points or fees and discount points.

(5) *Creditor that is a loan originator.* If the creditor is a loan originator, as defined in § 226.36(a)(1), and the creditor presents the consumer a covered transaction offered by a person to which the creditor would assign the covered transaction after consummation, the creditor must present the consumer an alternative covered transaction without a prepayment penalty that satisfies the requirements of paragraph (g)(3) of this section, offered by—

(i) The assignee; or

(ii) Another person, if the transaction offered by the other person has a lower interest rate or a lower total dollar amount of origination points or fees and discount points.

(6) *Applicability.* This paragraph (g) applies only if a covered transaction is consummated with a prepayment penalty and is not violated if:

(i) A covered transaction is consummated without a prepayment penalty; or

(ii) The creditor and consumer do not consummate a covered transaction.

(h) *Evasion; open-end credit.* In connection with credit secured by a consumer's dwelling that does not meet the definition of open-end credit in § 226.2(a)(20), a creditor shall not structure a home-secured loan as an open-end plan to evade the requirements of this section.◀

7. In Supplement I to Part 226:

A. Under *Section 226.25—Record Retention, 25(a) General rule,* paragraph 2 is revised and paragraphs 6 and 7 are added.

B. Under *Section 226.32—Requirements for Certain Closed-End Home Mortgages,*

(1) In subheading *32(a) Coverage, Paragraph 32(a)(1)(ii),* paragraph 1 is revised;

(2) In subheading *32(b) Definitions, Paragraph 32(b)(1)(i),* paragraph 1 is revised and paragraphs 2, 3, and 4 are added;

(i) *Paragraph 32(b)(1)(ii),* paragraph 1 is revised, paragraph 2. is redesignated as *Paragraph 32(b)(1)(iii),* paragraph 1, and revised, and new paragraphs 2 and 3 are added to *Paragraph 32(b)(1)(ii);*

(ii) *Paragraph 32(b)(1)(iv),* paragraph 1 is revised and paragraph 2 is added.

C. Under *Section 226.34—Prohibited Acts or Practices in Connection with Credit Subject to § 226.32,* subheading *34(a) Prohibited acts or practices for loans subject to § 226.32,* paragraph *34(a)(4) Repayment ability* is removed and reserved.

D. *Section 226.35—Prohibited Acts or Practices in Connection with Higher-*

Priced Mortgage Loans is removed and reserved.

E. New entry *Section 226.43—Minimum Standards for Transactions Secured by a Dwelling* is added.

The revisions, removals, and additions read as follows:

Supplement I to Part 226—Official Staff Interpretations

* * * * *

Subpart D—Miscellaneous

* * * * *

Section 226.25—Record Retention

25(a) General rule.

* * * * *

2. *Methods of retaining evidence.* Adequate evidence of compliance does not necessarily mean actual paper copies of disclosure statements or other business records. The evidence may be retained [on microfilm, microfiche, or] by any [other] method that reproduces records accurately (including computer programs). ►Unless otherwise required,◄ the creditor need retain only enough information to reconstruct the required disclosures or other records. Thus, for example, the creditor need not retain each open-end periodic statement, so long as the specific information on each statement can be retrieved.

* * * * *

►6. *Evidence of compliance with § 226.43.* Creditors must retain evidence of compliance with § 226.43 for three years after the date of consummation of a consumer credit transaction covered by that section. (See comment 25(a)–7 for guidance on the retention of evidence of compliance with the requirement to offer a consumer a loan without a prepayment penalty under § 226.43(g)(3).) If a creditor must verify and document information used in underwriting a transaction subject to § 226.43, the creditor should retain evidence sufficient to demonstrate compliance with the documentation requirements of the rule. Although creditors need not retain actual paper copies of the documentation used in underwriting a transaction subject to § 226.43, creditors should be able to reproduce such records accurately. For example, if the creditor uses a consumer's Internal Revenue Service (IRS) Form W–2 to verify the consumer's income, the creditor should be able to reproduce the IRS Form W–2 itself, and not merely the income information that was contained in the form.

7. *Dwelling-secured transactions and prepayment penalties.* If a transaction covered by § 226.43 has a prepayment penalty, the creditor must maintain records that document that the creditor complied with requirements for offering the consumer an alternative transaction that does not include a prepayment penalty under § 226.43(g)(3), (4), or (5). However, the creditor need not maintain records that document compliance with those provisions if a transaction is consummated without a prepayment penalty or if the creditor and consumer do not consummate a covered transaction. *See* § 226.43(g)(6). If a creditor offers a transaction with a prepayment penalty to a consumer through a mortgage broker, to evidence compliance with § 226.43(g)(4) the creditor should retain records of the alternative covered transaction presented to the mortgage broker, such as a rate sheet, and the agreement with the mortgage broker required by § 226.43(g)(4)(ii).◄

* * * * *

Subpart E—Special Rules for Certain Home Mortgage Transactions

* * * * *

Section 226.32—Requirements for Certain Closed-End Home Mortgages

32(a) Coverage.

* * * * *

Paragraph 32(a)(1)(ii).

1. *Total loan amount.* For purposes of the "points and fees" test, the total loan amount is calculated by taking the amount financed, as determined according to § 226.18(b), and deducting any cost listed in § 226.32(b)(1)(iii)►,◄ [and 226.32] (b)(1)(iv)►and (b)(1)(vi)◄ that is both included as points and fees under § 226.32(b)(1) and financed by the creditor. Some examples follow, each using a $10,000 amount borrowed, a $300 appraisal fee, and $400 in points. A $500 ►single◄ premium for optional credit ►unemployment◄ [life] insurance is used in one example.

i. If the consumer finances a $300 fee for a creditor-conducted appraisal and pays $400 in points at closing, the amount financed under § 226.18(b) is $9,900 ($10,000 plus the $300 appraisal fee that is paid to and financed by the creditor, less $400 in prepaid finance charges). The $300 appraisal fee paid to the creditor is added to other points and fees under § 226.32(b)(1)(iii). It is deducted from the amount financed ($9,900) to derive a total loan amount of $9,600.

ii. If the consumer pays the $300 fee for the creditor-conducted appraisal in cash at closing, the $300 is included in the points and fees calculation because it is paid to the creditor. However, because the $300 is not financed by the creditor, the fee is not part of the amount financed under § 226.18(b). In this case, the amount financed is the same as the total loan amount: $9,600 ($10,000, less $400 in prepaid finance charges).

iii. If the consumer finances a $300 fee for an appraisal conducted by someone other than the creditor or an affiliate, the $300 fee is not included with other points and fees under § 226.32(b)(1)(iii). ►In this case, the amount financed is the same as the total loan amount:◄ $9,900 ($10,000 plus the $300 fee for an independently conducted appraisal that is financed by the creditor, less the $400 paid in cash and deducted as prepaid finance charges).

iv. If the consumer finances a $300 fee for a creditor-conducted appraisal and a $500 single premium for optional credit ►unemployment◄ [life] insurance, and pays $400 in points at closing, the amount financed under § 226.18(b) is $10,400 ($10,000, plus the $300 appraisal fee that is paid to and financed by the creditor, plus the $500 insurance premium that is financed by the creditor, less $400 in prepaid finance charges). The $300 appraisal fee paid to the creditor is added to other points and fees under § 226.32(b)(1)(iii), and the $500 insurance premium is added under section 226.32(b)(1)(iv). The $300 and $500 costs are deducted from the amount financed ($10,400) to derive a total loan amount of $9,600.

* * * * *

32(b) Definitions.

Paragraph 32(b)(1)(i)

1. *General.* Section 226.32(b)(1)(i) includes in the total "points and fees" items defined as finance charges under § 226.4(a) and 226.4(b). Items excluded from the finance charge under other provisions of § 226.4 are not excluded in the total "points and fees" under § 226.32(b)(1)(i), but may be included in "points and fees" under § 226.32(b)(1)(ii) ►through § 226.32(b)(1)(vi).◄[and § 226.32(b)(1)(iv)]. Interest, including per diem interest, is excluded from "points and fees under § 226.32(b)(1). ►To illustrate: A fee imposed by the creditor for an appraisal performed by an employee of the creditor meets the definition of "finance charge" under § 226.4(a) as "any charge payable directly or indirectly by the consumer and imposed directly or indirectly by the creditor as an incident to or a condition of the extension of credit." However, § 226.4(c)(7) expressly provides that appraisal fees are not finance charges. Therefore, under the general rule regarding the finance

charges that must be counted as points and fees, a fee imposed by the creditor for an appraisal performed by an employee of the creditor would not be counted in points and fees. Section 226.32(b)(1)(iii), however, expressly re-includes in points and fees items listed in § 226.4(c)(7) (including appraisal fees) if the creditor receives compensation in connection with the charge. A creditor would receive compensation for an appraisal performed by its own employee. Thus, the appraisal fee in this example must be included in the calculation of points and fees.

2. *Upfront Federal and state mortgage insurance premiums and guaranty fees.* Under § 226.32(b)(1)(i)(B)(*1*) and (*3*), upfront mortgage insurance premiums or guaranty fees in connection with a Federal or state agency program are not "points and fees," even though they are finance charges under § 226.4(a) and (b). For example, if a consumer is required to pay a $2,000 mortgage insurance premium before or at closing for a loan insured by the U.S. Federal Housing Administration, the $2,000 must be treated as a finance charge but need not be counted in "points and fees."

3. *Upfront private mortgage insurance premiums.* i. Under § 226.32(b)(1)(i)(B)(*2*) and (*3*), upfront private mortgage insurance premiums are not "points and fees," even though they are finance charges under § 226.4(a) and (b)—but only to the extent that the premium amount does not exceed the amount payable under policies in effect at the time of origination under section 203(c)(2)(A) of the National Housing Act (12 U.S.C. 1709(c)(2)(A)).

ii. In addition, to qualify for the exclusion from points and fees, upfront private mortgage insurance premiums must be required to be refunded on a pro rata basis and the refund must be automatically issued upon notification of the satisfaction of the underlying mortgage loan.

iii. To illustrate: Assume that a $3,000 upfront private mortgage insurance premium charged on a covered transaction is required to be refunded on a pro rata basis and automatically issued upon notification of the satisfaction of the underlying mortgage loan. Assume also that the maximum upfront premium allowable under the National Housing Act is $2,000. In this case, the creditor could exclude $2,000 from "points and fees" but would have to include the $1,000 that exceeds the allowable premium under the National Housing Act. However, if the $3,000 upfront private mortgage insurance premium were not required to be refunded on a pro rata basis and automatically issued upon notification of the satisfaction of the underlying mortgage loan, the entire $3,000 premium must be included in "points and fees."

4. *Method of paying private mortgage insurance premiums.* Upfront private mortgage insurance premiums that do not qualify for an exclusion from "points and fees" under § 226.32(b)(1)(i)(B)(*2*) must be included in "points and fees" for purposes of this section whether paid before or at closing, in cash or financed, and whether the insurance is optional or required. Such charges are also included whether the amount represents the entire premium or an initial payment.◄

Paragraph 32(b)(1)(ii).

1. [*Mortgage broker fees*]►*Loan originator compensation—general*◄. In determining "points and fees" for purposes of this section, compensation paid by a consumer ►or creditor◄ to a ►loan originator◄ [mortgage broker (directly or through the creditor for delivery to the broker)] is included in the calculation whether or not the amount is disclosed as a finance charge. [Mortgage broker fees that are not paid by the consumer are not included.] ►Loan originator◄[Mortgage broker] fees already included in ►points and fees◄ calculation as finance charges under § 226.32(b)(1)(i) need not be counted again under § 226.32(b)(1)(ii).

►2. *Loan originator compensation—examples.* i. In determining "points and fees" under this section, loan originator compensation includes the dollar value of compensation paid to a loan originator for a covered transaction, such as a bonus, commission, yield spread premium, award of merchandise, services, trips, or similar prizes, or hourly pay for the actual number of hours worked on a particular transaction. Compensation paid to a loan originator for a covered transaction must be included in the "points and fees" calculation for that loan whenever paid, whether before, at, or after closing, as long as that compensation amount can be determined at the time of closing. Thus, loan originator compensation for a covered transaction includes compensation that will be paid as part of a periodic bonus, commission, or gift if a portion of the dollar value of the bonus, commission, or gift can be attributed to that loan. The following examples illustrate the rule:

A. Assume that, according to a creditor's compensation policies, the creditor awards its loan officers a bonus every year based on the number of loan applications taken by the loan officer that result in consummated transactions during that year, and that each consummated transaction increases the bonus by $100. In this case, the $100 bonus must be counted in the amount of loan originator compensation that the creditor includes in "points and fees."

B. Assume that, according to a creditor's compensation policies, the creditor awards its loan officers a year-end bonus equal to a flat dollar amount for each of the consummated transactions originated by the loan officer during that year. Assume also that the per-transaction dollar amount is determined at the end of the year, based on the total dollar value of consummated transactions originated by the loan officer. If at the time a mortgage transaction is consummated the loan officer has originated total volume that qualifies the loan officer to receive a $300 bonus per transaction, the $300 bonus is loan originator compensation that must be included in "points and fees" for the transaction.

C. Assume that, according to a creditor's compensation policies, the creditor awards its loan officers a bonus every year based on the number of consummated transactions originated by the loan officer during that year. Assume also that for the first 10 transactions originated by the loan officer in a given year, no bonus is awarded; for the next 10 transactions originated by the loan officer up to 20, a bonus of $100 per transaction is awarded; and for each transaction originated after the first 20, a bonus of $200 per transaction is awarded. In this case, for the first 10 transactions originated by a loan officer during a given year, no amount of loan originator compensation need be included in "points and fees." For any mortgage transaction made after the first 10, up to the 20th transaction, $100 must be included in "points and fees." For any mortgage transaction made after the first 20, $200 must be included in "points and fees."

ii. In determining "points and fees" under this section, loan originator compensation excludes compensation that cannot be attributed to a particular transaction at the time or origination, including, for example:

A. Compensation based on the long-term performance of the loan originator's loans.

B. Compensation based on the overall quality of a loan originator's loan files.

C. The base salary of a loan originator who is also the employee of the creditor, not accounting for any bonuses, commissions, pay raises, or other financial awards based solely on a particular transaction or the number or amount of covered transactions originated by the loan originator.

3. *Name of fee.* Loan originator compensation includes amounts the loan originator retains and is not dependent on the label or name of any fee imposed in connection with the transaction. For example, if a loan originator imposes a "processing fee" and retains the fee, the fee is loan originator compensation under § 226.32(b)(1)(ii) whether the originator expends the fee to process the consumer's application or uses it for other expenses, such as overhead.

Paragraph 32(b)(1)(iii).

1. *Other charges.*◄[2. *Example.*] Section 32(b)(1)(iii) defines "points and fees" to include all items listed in § 226.4(c)(7), other than amounts held for the future payment of taxes. An item listed in § 226.4(c)(7) may be excluded from the "points and fees" calculation, however, if the charge is reasonable►; ◄[,] the creditor receives no direct or indirect compensation from the charge►;◄[,] and the charge is not paid to an affiliate of the creditor. For example, a reasonable fee paid by the consumer to an independent, third-party appraiser may be excluded from the "points and fees" calculation (assuming no compensation is paid to the creditor► or its affiliate◄). ►By contrast, a◄[A] fee paid by the consumer for an appraisal performed by the creditor must be included in the calculation, even though the fee may be excluded from the finance charge if it is bona fide and reasonable in amount.

Paragraph 32(b)(1)(iv).

1. ►*Credit insurance and debt cancellation or suspension coverage* ◄[*Premium amount*]. In determining "points and fees" for purposes of this section, premiums paid at or before closing for credit insurance or ►any debt cancellation or suspension agreement or contract◄ are included ►in "points and fees" if they are paid at or before closing,◄ whether they are paid in cash or financed, ►and whether the insurance or coverage is optional or required. Such charges are also included◄[and] whether the amount represents the entire premium or payment for the coverage or an initial payment.

►2. *Credit property insurance.* Credit property insurance includes insurance against loss of or damage to personal property, such as a houseboat or manufactured home. Credit property insurance covers the creditor's security interest in the property. Credit property insurance does not include homeowners insurance, which, unlike credit property insurance, typically covers not only the dwelling but its contents, and designates the consumer, not the creditor, as the beneficiary.◄

* * * * *

Section 226.34—Prohibited Acts or Practices in Connection with Credit Subject to § 226.32

34(a) Prohibited acts or practices for loans subject to § 226.32.

* * * * *

34(a)(4) Repayment ability.

►[Reserved.]◄

* * * * *

Section 226.35 ►[*Reserved.*]◄

* * * * *

►*Section 226.43—Minimum Standards for Transactions Secured by a Dwelling*

1. *Record retention.* See § 226.25(a) and comments 25(a)–6 and –7 for guidance on the required retention of records as evidence of compliance with § 226.43.

43(a) Scope.

1. *Consumer credit.* In general, § 226.43 applies to consumer credit transactions secured by a dwelling, but certain dwelling-secured consumer credit transactions are exempt from coverage under § 226.43(a)(1)–(3). (*See* § 226.2(a)(12) for the definition of "consumer credit.") Section 226.43 does not apply to an extension of credit primarily for a business, commercial, or agricultural purpose, even if it is secured by a dwelling. *See* § 226.3 and associated commentary for guidance in determining the primary purpose of an extension of credit.

2. *Real property.* "Dwelling" means a residential structure that contains one to four units, whether or not the structure is attached to real property. *See* § 226.2(a)(19). For purposes of § 226.43, the term "dwelling" includes any real property to which the residential structure is attached that also secures the covered transaction. For example, for purposes of § 226.43(c)(2)(i), the value of the dwelling that secures the covered transaction includes the value of any real property to which the residential structure is attached that also secures the covered transaction.

3. *Renewable temporary or "bridge" loan.* Under § 226.43(a)(3)(ii), a temporary or "bridge" loan with a term of 12 months or less is excluded from coverage by § 226.43(c) through (f). Examples of such a loan are a loan to finance the purchase of a new dwelling where the consumer plans to sell a current dwelling within 12 months and a loan to finance the initial construction of a dwelling. Where a temporary or "bridge loan" is renewable, the loan term does not include any additional period of time that could result from a renewal provision. For example, if a construction loan has an initial loan term of 12 months but is renewable for another 12-month loan term, the loan is excluded from coverage by § 226.43(c) through (f), because the initial loan term is 12 months.

43(b) Definitions.

43(b)(3) Fully indexed rate.

1. *Discounted and premium adjustable-rate transactions.* In some adjustable-rate transactions, creditors may set an initial interest rate that is not determined by the index or formula used to make later interest rate adjustments. Typically, this initial rate charged to consumers is lower than the rate would be if it were calculated using the index or formula at consummation (*i.e.,* a "discounted rate"). In some cases, this initial rate may be higher (*i.e.,* a "premium rate"). For purposes of determining the fully indexed rate where the initial interest rate is not determined using the index or formula for subsequent interest rate adjustments, the creditor must use the interest rate that would have applied had the creditor used such index or formula plus margin at the time of consummation. That is, in determining the fully indexed rate, the creditor must not take into account any discounted or premium rate. To illustrate, assume an adjustable-rate transaction where the initial interest rate is not based on an index or formula, and is set at 5% for the first five years. The loan agreement provides that future interest rate adjustments will be calculated based on the London Interbank Offered Rate (LIBOR) plus a 3% margin. If the value of the LIBOR at consummation is 5%, the interest rate that would have been applied at consummation had the creditor based the initial rate on this index is 8% (5% plus 3% margin). For purposes of this section, the fully indexed rate is 8%. For discussion of payment calculations based on the greater of the fully indexed rate or "premium rate" for purposes of the repayment ability determination under § 226.43(c), *see* § 226.43(c)(5)(i) and comment 43(c)(5)(i)–2.

2. *Index or formula at consummation.* The value of the index or formula in effect at consummation need not be used if the contract provides for a delay in the implementation of changes in an index value or formula. For example, if the contract specifies that rate changes are based on the index value in effect 45 days before the change date, the creditor may use any index value in effect during the 45 days before

consummation in calculating the fully indexed rate.

3. *Interest rate adjustment caps.* If the terms of the legal obligation contain a periodic interest rate adjustment cap that would prevent the initial rate, at the time of the first adjustment, from changing to the rate determined using the index or formula at consummation (*i.e.,* the fully indexed rate), the creditor must not give any effect to that rate cap when determining the fully indexed rate. That is, a creditor must determine the fully indexed rate without taking into account any periodic interest rate adjustment cap that may limit how quickly the fully indexed rate may be reached at any time during the loan term under the terms of the legal obligation. To illustrate, assume an adjustable-rate mortgage has an initial fixed rate of 5% for the first three years of the loan, 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 a lifetime maximum interest rate of 10%. The index value in effect at consummation is 4.5%; the fully indexed rate is 7.5% (4.5% plus 3%), regardless of the 2% annual interest rate adjustment cap that would limit when the fully indexed rate would take effect under the terms of the legal obligation.

4. *Lifetime maximum interest rate.* A creditor may choose, in its sole discretion, to take into account the lifetime maximum interest rate provided under the terms of the legal obligation when determining the fully indexed rate. If the creditor chooses to use the lifetime maximum interest rate and the loan agreement provides a range for the maximum interest rate, then the creditor must use the highest rate in that range as the maximum interest rate for purposes of this section. To illustrate, assume an adjustable-rate mortgage has an initial fixed rate of 5% for the first three years of the loan, 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 a lifetime maximum interest rate of 7%. The index value in effect at consummation is 4.5%; the fully indexed rate is 7.5% (4.5% plus 3%). For purposes of this section, the creditor can choose to use the lifetime maximum interest rate of 7%, instead of the fully indexed rate of 7.5%, for purposes of this section.

5. *Step-rate and fixed-rate mortgages.* Where the interest rate offered under the terms of the legal obligation is not based on, and does not vary with, an index or formula (*i.e.,* there is no fully indexed rate), the creditor must use the maximum interest rate that may apply at any time during the loan term. To illustrate:

i. Assume a step-rate mortgage with an interest rate fixed at 6.5% for the first two years of the loan, 7% for the next three years, and 7.5% thereafter for the remainder of loan term. For purposes of this section, the creditor must use 7.5%, which is the maximum rate that may apply during the loan term. "Step-rate mortgage" is defined in § 226.18(s)(7)(ii).

ii. Assume a fixed-rate mortgage with an interest rate at consummation of 7% that is fixed for the 30-year loan term. For purposes of this section, the maximum interest rate that may apply during the loan term is 7%, which is the interest rate that is fixed at consummation. "Fixed-rate mortgage" is defined in § 226.18(s)(7)(iii).

43(b)(4) Higher-priced covered transaction.

1. *Average prime offer rate.* The average prime offer rate generally has the same meaning as in § 226.45(a)(2)(ii). For further explanation of the meaning of "average prime offer rate," and additional guidance on determining the average prime offer rate, *see* comments 45(a)(2)(ii)–1 and –5. For further explanation of the Board table, *see* comment 45(a)(2)(ii)–4.

2. *Comparable transaction.* A higher-priced covered transaction is a consumer credit transaction that is secured by the consumer's dwelling with an annual percentage rate that exceeds the average prime offer rate for a comparable transaction as of the date the interest rate is set by the specified amount. The table of average prime offer rates published by the Board indicates how to identify a comparable transaction. *See* comment 45(a)(2)(ii)–2.

3. *Rate set.* A transaction's annual percentage rate is compared to the average prime offer rate as of the date the transaction's interest rate is set (or "locked") before consummation. Sometimes a creditor sets the interest rate initially and then re-sets it at a different level before consummation. The creditor should use the last date the interest rate is set before consummation.

43(b)(5) Loan amount.

1. *Disbursement of the loan amount.* The definition of "loan amount" requires the creditor to use the entire loan amount as reflected in the loan contract or promissory note, even though the loan amount may not be fully disbursed at consummation. For example, assume the consumer enters into a loan agreement where the consumer is obligated to repay the creditor $200,000 over 15 years, but only $100,000 is disbursed at consummation and the remaining $100,000 will be disbursed during the year following consummation in a series of advances ($25,000 each quarter). For purposes of this section, the creditor must use the loan amount of $200,000, even though the loan agreement provides that only $100,000 will be disbursed to the consumer at consummation. Generally, creditors should rely on § 226.17(c)(6) and associated commentary regarding treatment of multiple-advance and construction-to-permanent loans as single or multiple transactions.

43(b)(6) Loan term.

1. *General.* The loan term is the period of time it takes to repay the loan amount in full. For example, a loan with an initial discounted rate that is fixed for the first two years, and that adjusts periodically for the next 28 years has a loan term of 30 years, which is the amortization period on which the periodic amortizing payments are based.

43(b)(7) Maximum loan amount.

1. *Calculation of maximum loan amount.* For purposes of § 226.43(c)(2)(iii) and (c)(5)(ii)(C), a creditor must determine the maximum loan amount for a negative amortization loan by using the loan amount plus any increase in principal balance that will result from negative amortization based on the terms of the legal obligation. In determining the maximum loan amount, a creditor must assume that the consumer makes the minimum periodic payment permitted under the loan agreement for as long as possible, until the consumer must begin making fully amortizing payments; and that the interest rate rises as quickly as possible after consummation under the terms of the legal obligation. Thus, creditors must assume that the consumer makes the minimum periodic payment until any negative amortization cap is reached or until the period permitting minimum periodic payments expires, whichever occurs first. "Loan amount" is defined in § 226.43(b)(5); "negative amortization loan" is defined in § 226.18(s)(7)(v).

2. *Assumed interest rate.* In calculating the maximum loan amount for an adjustable-rate mortgage that is a negative amortization loan, the creditor must assume that the interest rate will increase as rapidly as possible after consummation, taking into account any periodic interest rate adjustment caps provided in the loan agreement. For an adjustable-rate mortgage with a lifetime maximum interest rate but no periodic interest rate adjustment cap, the creditor must assume that the interest rate increases to the maximum lifetime interest rate at the first adjustment.

3. *Examples.* The following are examples of how to determine the maximum loan amount for a negative amortization loan (all amounts are rounded):

i. *Adjustable-rate mortgage with negative amortization.* A. Assume an adjustable-rate mortgage in the amount of $200,000 with a 30-year loan term. The loan agreement provides that the consumer can make minimum monthly payments that cover only part of the interest accrued each month until the principal balance reaches 115% of its original balance (*i.e.,* a negative amortization cap of 115%) or for the first five years of the loan (60 monthly payments), whichever occurs first. The introductory interest rate at consummation is 1.5%. One month after consummation, the interest rate adjusts and will adjust monthly thereafter based on the specified index plus a margin of 3.5%. The maximum lifetime interest rate is 10.5%; there are no other periodic interest rate adjustment caps that limit how quickly the maximum lifetime rate may be reached. The minimum monthly payment for the first year is based on the initial interest rate of 1.5%. After that, the minimum monthly payment adjusts annually, but may increase by no more than 7.5% over the previous year's payment. The minimum monthly payment is $690 in the first year, $742 in the second year, and $798 in the first part of the third year.

B. To determine the maximum loan amount, assume that the initial interest rate increases to the maximum lifetime interest rate of 10.5% at the first adjustment (*i.e.,* the second month) and accrues at that rate until the loan is recast. Assume the consumer makes the minimum monthly payments as scheduled, which are capped at 7.5% from year-to-year. As a result, the consumer's minimum monthly payments are less than the interest accrued each month, resulting in negative amortization (*i.e.,* the accrued but unpaid interest is added to the principal balance). Thus, assuming that the consumer makes the minimum monthly payments for as long as possible and that the maximum interest rate of 10.5% is reached at the first rate adjustment (*i.e.,* the second month), the negative amortization cap of 115% is reached on the due date of the 27th monthly payment and the loan is recast. The maximum loan amount as of the due date of the 27th monthly payment is $229,243.

ii. *Fixed-rate, graduated payment mortgage with negative amortization.* A loan in the amount of $200,000 has a 30-year loan term. The loan agreement provides for a fixed interest rate of 7.5%, and requires the consumer to make minimum monthly payments during the first year, with payments increasing 12.5% every year for four years. The payment schedule provides for payments of $943 in the first year, $1,061 in the second year, $1,194 in the third year, $1,343 in the fourth year, and $1,511 for the remaining term of the loan. During the first three years of the loan, the payments are less than the interest accrued each month, resulting in negative amortization. Assuming that the consumer makes the minimum periodic payments for as long as possible, the maximum loan amount is $207,659, which is reached at the end of the third year of the loan (on the due date of the 36th monthly payment). *See* comment 43(c)(5)(ii)(C)–3 providing examples of how to determine the consumer's repayment ability for a negative amortization loan.

43(b)(8) Mortgage-related obligations.

1. *General.* Mortgage-related obligations include expected property taxes and premiums for mortgage-related insurance required by the creditor as set forth in § 226.45(b)(1), such as insurance against loss of or damage to property or against liability arising out of the ownership or use of the property, and insurance protecting the creditor against the consumer's default or other credit loss. A creditor need not include premiums for mortgage-related insurance that it does not require, such as an earthquake insurance or credit insurance, or fees for optional debt suspension and debt cancellation agreements. Mortgage-related obligations also include special assessments that are imposed on the consumer at or before consummation, such as a one-time homeowners' association fee that will not be paid by the consumer in full at or before consummation. *See* commentary to § 226.43(c)(2)(v), discussing the requirement to take into account any mortgage-related obligations.

43(b)(10) Prepayment penalty.

Paragraph 43(b)(10)(i)(A).

1. *Interest accrual amortization method.* A prepayment penalty includes charges determined by treating the loan balance as outstanding for a period after prepayment in full and applying the interest rate to such balance, even if the charge results from the interest accrual amortization method used on the transaction. "Interest accrual amortization" refers to the method by which the amount of interest due for each period (*e.g.,* month), in a transaction's term is determined. For example, "monthly interest accrual amortization" treats each payment as made on the scheduled, monthly due date even if it is actually paid early or late (until the expiration of a grace period). Thus, under monthly interest accrual amortization, if the amount of interest due on May 1 for the preceding month of April is $3000, the creditor will require payment of $3000 in interest whether the payment is made on April 20, on May 1, or on May 10. In this example, if the interest charged for the month of April upon prepayment in full on April 20 is $3000, the charge constitutes a prepayment penalty of $1000 because the amount of interest actually earned through April 20 is only $2000.

43(b)(11) Recast.

1. *Date of the recast.* The term "recast" means, for an adjustable-rate mortgage, the expiration of the period during which payments based on the introductory fixed rate are permitted; for an interest-only loan, the expiration of the period during which the interest-only payments are permitted; and, for a negative amortization loan, the expiration of the period during which negatively amortizing payments are permitted. For adjustable-rate mortgages, interest-only loans, and negative amortization loans, the date on which the "recast" is considered to occur is the due date of the last monthly payment based on the introductory fixed rate, the interest-only payment, or the negatively amortizing payment, respectively. To illustrate: A loan in an amount of $200,000 has a 30-year loan term. The loan agreement provides for a fixed interest rate and permits interest-only payments for the first five years of the loan (60 months). The loan is recast on the due date of the 60th monthly payment. Thus, the term of the loan remaining as of the date the loan is recast is 25 years (300 months).

43(b)(12) Simultaneous loan.

1. *General.* Section 226.43(b)(12) defines a simultaneous loan as another covered transaction or home equity line of credit subject to § 226.5b (HELOC) that will be secured by the same dwelling and made to the same consumer at or before consummation of the covered transaction, whether it is made by the same creditor or a third-party creditor. For example, assume a consumer will enter into a legal obligation that is a covered transaction with Creditor A. Immediately prior to consummation of the covered transaction with Creditor A, the consumer opens a HELOC that is secured by the same dwelling with Creditor B. For purposes of this section, the loan extended by Creditor B is a simultaneous loan. *See* commentary to

§ 226.43(c)(2)(iv) and (c)(6), discussing the requirement to consider the consumer's payment obligation on any simultaneous loan for purposes of determining the consumer's ability to repay the covered transaction subject to this section.

2. *Same consumer.* For purposes of the definition of "simultaneous loan," the term "same consumer" includes any consumer, as that term is defined in § 226.2(a)(11), that enters into a loan that is a covered transaction and also enters into another loan (*e.g.,* second-lien covered transaction or HELOC) secured by the same dwelling. Where two or more consumers enter into a legal obligation that is a covered transaction, but only one of them enters into another loan secured by the same dwelling, the "same consumer" includes the person that has entered into both legal obligations. For example, assume Consumer A and Consumer B will both enter into a legal obligation that is a covered transaction with a creditor. Immediately prior to consummation of the covered transaction, Consumer B opens a HELOC that is secured by the same dwelling with the same creditor; Consumer A is not a signatory to the HELOC. For purposes of this definition, Consumer B is the same consumer and the creditor must include the HELOC as a simultaneous loan.

43(b)(13) Third-party record.

1. *Electronic records.* Third-party records include records transmitted electronically. For example, to verify a consumer's credit history using third-party records as required by § 226.43(c)(2)(viii) and 226.43(c)(3), creditors may use a credit report prepared by a consumer reporting agency and transmitted or viewed electronically.

2. *Forms.* A record prepared by a third party includes a form a creditor gives a third party for providing information, even if the creditor completes parts of the form unrelated to the information sought. For example, if a creditor gives a consumer's employer a form for verifying the consumer's employment status and income, the creditor may fill in the creditor's name and other portions of the form unrelated to the consumer's employment status or income.

Paragraph 43(b)(13)(i).

1. *Reviewed record.* Under § 226.43(b)(13)(i), a third-party record includes a document or other record prepared by the consumer, the creditor, the mortgage broker, or the creditor's or mortgage broker's agent, if the record is reviewed by a third party. For example, a profit-and-loss statement prepared by a self-employed consumer and reviewed by a third-party accountant is a third-party record under § 226.43(b)(13)(i).

Paragraph 43(b)(13)(iii).

1. *Creditor's records.* Section 226.43(b)(13)(iii) provides that third-party record includes a record the creditor maintains for an account of the consumer held by the creditor. Examples of such accounts include checking accounts, savings accounts, and retirement accounts. Examples of such accounts also include accounts related to a consumer's outstanding obligations to a creditor. For example, a third-party record includes the creditor's records for a first-lien mortgage to a consumer who applies for a subordinate-lien home equity loan.

43(c) Repayment ability.

1. *Widely accepted standards.* To evaluate a consumer's repayment ability under § 226.43(c), creditors may look to widely accepted governmental or non-governmental underwriting standards, such as the Federal Housing Administration's handbook on Mortgage Credit Analysis for Mortgage Insurance on One- to Four-Unit Mortgage Loans. For example, creditors may use such standards in determining:

i. Whether to classify particular inflows, obligations, or property as "income," "debt," or "assets";

ii. Factors to consider in evaluating the income of a self-employed or seasonally employed consumer; and

iii. Factors to consider in evaluating the credit history of a consumer who has obtained few or no extensions of traditional "credit," as defined in § 226.2(a)(14).

43(c)(1) General requirement.

1. *Repayment ability at consummation.* Section 226.43(c)(1) requires the creditor to determine that a consumer will have a reasonable ability at the time the loan is consummated to repay the loan. A change in the consumer's circumstances after consummation (for example, a significant reduction in income due to a job loss or a significant obligation arising from a major medical expense) that is not reflected in the consumer's application or the records used to determine repayment ability is not relevant to determining a creditor's compliance with the rule. However, if the application or records state there will be a change in a consumer's repayment ability after consummation (for example, if a consumer's application states that the consumer plans to retire within 12 months without obtaining new employment or that the consumer will transition from full-time to part-time employment), the creditor must consider that information.

2. *Interaction with Regulation B.* Section 226.43(c)(1) does not require or permit the creditor to make inquiries or verifications that would be prohibited by Regulation B, 12 CFR part 202.

Paragraph 43(c)(2)(i).

1. *Income or assets generally.* A creditor may base its determination of repayment ability on current or reasonably expected income from employment or other sources, assets other than the dwelling that secures the covered transaction, or both. The creditor may consider any type of current or reasonably expected income, including, for example, the following: Salary; wages; self-employment income; military or reserve duty income; bonus pay; tips; commissions; interest payments; dividends; retirement benefits or entitlements; rental income; royalty payments; trust income; public assistance payments; and alimony, child support, and separate maintenance payments. The creditor may consider any of the consumer's assets, other than the value of the dwelling that secures the covered transaction, including, for example, the following: funds in a savings or checking account, amounts vested in a retirement account, stocks, bonds, certificates of deposit, and amounts available to the consumer from a trust fund. (For purposes of § 226.43(c)(2)(i), the value of the dwelling includes the value of the real property to which the real property is attached, if the real property also secures the covered transaction. *See* comment 43(a)–2.)

2. *Income or assets relied on.* If a creditor bases its determination of repayment ability entirely or in part on a consumer's income, the creditor need consider only the income necessary to support a determination that the consumer can repay the covered transaction. For example, 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. Further, a creditor need verify only the income (and assets) relied on to determine the consumer's repayment ability. *See* comment 43(c)(4)–1.

3. *Expected income.* If a creditor relies on expected income, either in addition to or instead of current income, the expectation that the income will be available for repayment must be reasonable and verified with third-party records that provide reasonably reliable evidence of the consumer's expected

income. For example, if the creditor relies on an expectation that a consumer will receive an annual bonus, the creditor may verify the basis for that expectation with records that show the consumer's past annual bonuses, and the expected bonus must bear a reasonable relationship to the past bonuses. Similarly, if the creditor relies on a consumer's expected salary from a job the consumer has accepted and will begin after receiving an educational degree, the creditor may verify that expectation with a written statement from an employer indicating that the consumer will be employed upon graduation at a specified salary.

4. *Seasonal or irregular income.* A creditor reasonably may determine that a consumer can make periodic loan payments even if the consumer's income, such as self-employment income, is seasonal or irregular. For example, assume a consumer receives income during a few months each year from the sale of crops. If the creditor determines that the consumer's annual income divided equally across 12 months is sufficient for the consumer to make monthly loan payments, the creditor reasonably may determine that the consumer can repay the loan, even though the consumer may not receive income during certain months.

Paragraph 43(c)(2)(ii).

1. *Employment status and income.* Employment may be full-time, part-time, seasonal, irregular, military, or self-employment. Under § 226.43(c)(2)(ii), a creditor need verify a consumer's current employment status only if the creditor relies on the consumer's employment income in determining the consumer's repayment ability. 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. *See* comment 43(c)(4)–2 for guidance on which income to consider where multiple consumers apply jointly for a loan.

2. *Military personnel.* Creditors may verify the employment status of military personnel using the electronic database maintained by the Department of Defense to facilitate identification of consumers covered by credit protections provided pursuant to 10 U.S.C. 987.

Paragraph 43(c)(2)(iii).

1. *General.* For purposes of the repayment ability determination required under § 226.43(c)(2), a creditor must consider the consumer's monthly payment on a covered transaction that is calculated as required under § 226.43(c)(5), taking into account any mortgage-related obligations. "Mortgage-related obligations" is defined in § 226.43(b)(8).

Paragraph 43(c)(2)(iv).

1. *Home equity lines of credit.* For purposes of § 226.43(c)(2)(iv), a simultaneous loan includes any covered transaction or home equity line of credit subject to § 226.5b (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. A HELOC that is a simultaneous loan that the creditor knows or has reason to know about must be considered as a mortgage obligation in determining a consumer's ability to repay the covered transaction even though the HELOC is not a covered transaction subject to § 226.43. See § 226.43(a) discussing the scope of this section. "Simultaneous loan" is defined in § 226.43(b)(12). For further explanation of "same consumer," *see* comment 43(b)(12)–2.

2. *Knows or has reason to know.* In determining a consumer's repayment ability for a covered transaction under § 226.43(c)(2), a creditor must consider the consumer's payment obligation on any simultaneous loan that the creditor knows or has reason to know will be made at or before consummation of the covered transaction. For example, where a covered transaction is a home purchase loan, the creditor must consider the consumer's periodic payment obligation for any "piggyback" second-lien loan that the creditor knows or has reason to know will be used to finance part of the consumer's down payment. The creditor complies with this requirement where, for example, the creditor follows policies and procedures that show at or before consummation that the same consumer has applied for another credit transaction secured by the same dwelling. To illustrate, assume a creditor receives an application for a home purchase loan where the requested loan amount is less than the home purchase price. The creditor's policies and procedures require the consumer to state the source of the downpayment. If the creditor determines the source of the downpayment is another extension of credit that will be made to the same consumer at or before consummation and secured by the same dwelling, the creditor knows or has reason to know of the simultaneous loan and must consider the simultaneous loan. Alternatively, if the creditor has information that suggests the downpayment source is the consumer's income or existing assets, the creditor would be under no further obligation to determine whether a simultaneous loan will be extended at or before consummation of the covered transaction.

3. *Scope of timing.* For purposes of § 226.43(c)(2)(iv), a simultaneous loan includes a loan that comes into existence concurrently with the covered transaction subject to § 226.43(c). In all cases, a simultaneous loan does not include a credit transaction that occurs after consummation of the covered transaction that is subject to this section.

4. *Verification of simultaneous loans.* Although a credit report may be used to verify current obligations, it will not reflect a simultaneous loan that has not yet been consummated or has just recently been consummated. If the creditor knows or has reason to know that there will be a simultaneous loan extended at or before consummation, the creditor may verify the simultaneous loan by obtaining third-party verification from the third-party creditor of the simultaneous loan. For example, the creditor may obtain a copy of the promissory note or other written verification from the third-party creditor in accordance with widely accepted governmental or non-governmental standards. For further guidance, see comments 43(c)(3)–1 and –2 discussing verification using third-party records.

43(c)(2)(v) Mortgage-related obligations.

1. *General.* A creditor must include in its repayment ability assessment the consumer's mortgage-related obligations, such as the expected property taxes and premiums for mortgage-related insurance required by the creditor as set forth in § 226.45(b)(1), but need not include mortgage-related insurance premiums that the creditor does not require, such as credit insurance or fees for operational debt suspension and debt cancellation agreements. Mortgage-related obligations must be included in the creditor's determination of repayment ability regardless of whether the amounts are included in the monthly payment or whether there is an escrow account established. See § 226.43(b)(8) defining the term "mortgage-related obligations."

2. *Pro rata amount.* In considering mortgage-related obligations that are not paid monthly, a creditor may look to widely accepted governmental or non-governmental standards in determining the *pro rata* monthly payment amount.

3. *Estimates.* Estimates of mortgage-related obligations should be based upon information that is known to the creditor at the time the creditor underwrites the mortgage obligation.

Information is known if it is reasonably available to the creditor at the time of underwriting the loan. *See* comment 17(c)(2)(i)–1 discussing the "reasonably available" standard. For purposes of this section, the creditor need not project potential changes, such as by estimating possible increases in taxes and insurance.

4. *Verification of mortgage-related obligations.* Creditors must make the repayment ability determination required under § 226.43(c) based on information verified from reasonably reliable records. For guidance regarding verification of mortgage-related obligations see comments 43(c)(3)–1 and –2, which discuss verification using third-party records.

Paragraph 43(c)(2)(vi).

1. *Consideration and verification of current debt obligations.* In determining how to define "current debt obligations" and how to verify such obligations, creditors may look to widely accepted governmental and non-governmental underwriting standards. For example, a creditor must consider student loans, automobile loans, revolving debt, alimony, child support, and existing mortgages. To verify the obligations as required by § 226.43(c)(3), a creditor may, for instance, look to credit reports, student loan statements, automobile loan statements, credit card statements, alimony or child support court orders, and existing mortgage statements.

2. *Discrepancies between a credit report and an application.* If a credit report reflects a current debt obligation that a consumer has not listed on the application, the creditor must consider the obligation. The credit report is deemed a reasonably reliable third-party record under § 226.43(c)(3). If a credit report does not reflect a current debt obligation that a consumer has listed on the application, the creditor must consider the obligation. However, the creditor need not verify the existence or amount of the obligation through another source. If a creditor nevertheless verifies an obligation, the creditor must consider the obligation based on the information from the verified source.

Paragraph 43(c)(2)(vii).

1. *Monthly debt-to-income ratio and residual income. See* § 226.43(c)(7) regarding the definitions and calculations for the monthly debt-to-income ratio and residual income.

Paragraph 43(c)(2)(viii).

1. *Consideration and verification of credit history.* In determining how to define "credit history" and how to verify credit history, creditors may look to widely accepted governmental and non-governmental underwriting standards. For example, a creditor may consider factors such as the number and age of credit lines, payment history, and any judgments, collections, or bankruptcies. To verify credit history as required by § 226.43(c)(3), a creditor may, for instance, look to credit reports from credit bureaus, or nontraditional credit references contained in third-party documents, such as rental payment history or public utility payments.

43(c)(3) Verification using third-party records.

1. *Records specific to the individual consumer.* Records used to verify a consumer's repayment ability must be specific to the individual consumer. Records regarding average incomes in the consumer's geographic location or average incomes paid by the consumer's employer, for example, would not be specific to the individual consumer and are not sufficient.

2. *Obtaining records.* To determine repayment ability, creditors may obtain records from a third-party service provider, such as a party the consumer's employer uses to respond to income verification requests, as long as the records are reasonably reliable and specific to the individual consumer. Creditors also may obtain third-party records directly from the consumer. For example, creditors using payroll statements to verify the consumer's income (as allowed under § 226.43(c)(4)(iii) may obtain the payroll statements from the consumer.

43(c)(4) Verification of income or assets.

1. *Income or assets relied on.* A creditor need consider, and therefore need verify, only the income or assets the creditor relies on to evaluate the consumer's repayment ability. *See* comment 43(c)(2)(i)–2. 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.

2. *Multiple applicants.* If multiple consumers jointly apply for a loan and each lists income or assets on the application, the creditor need verify only the income or assets the creditor relies on in determining repayment ability.

3. *Tax-return transcript.* Under § 226.43(c)(4), creditors may verify a consumer's income using an Internal Revenue Service (IRS) tax-return transcript, which summarizes the information in a consumer's filed tax return, another record that provides reasonably reliable evidence of the consumer's income, or both. Creditors may obtain a copy of a tax-return transcript or a filed tax return directly from the consumer or from a service provider and need not obtain the copy directly from the IRS or other taxing authority. *See* comment 43(c)(3)–2.

Paragraph 43(c)(4)(vi).

1. *Government benefits.* In verifying a consumer's income, creditors may use a written or electronic record 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 (also known as a "budget letter," "benefits letter," or "proof of award letter").

43(c)(5) Payment calculation.

43(c)(5)(i) General rule.

1. *General.* For purposes of § 226.43(c)(2)(iii), a creditor must determine the consumer's ability to repay the covered transaction using the payment calculation methods set forth in § 226.43(c)(5). The payment calculation methods differ depending on whether the covered transaction has a balloon payment, or is an interest-only or negative amortization loan. The payment calculation method set forth in § 226.43(c)(5)(i) applies to any covered transaction that does not have a balloon payment, or that is not an interest-only or negative amortization loan, whether it is a fixed-rate, adjustable-rate or step-rate mortgage. The terms "fixed-rate mortgage," "adjustable-rate mortgage," "step-rate mortgage," "interest-only loan" and "negative amortization loan," are defined in § 226.18(s)(7)(i), (ii), (iii), (iv) and (v), respectively. For the meaning of the term "balloon payment," see § 226.18(s)(5)(i). The payment calculation method set forth in § 226.43(c)(5)(ii) applies to any covered transaction that is a loan with a balloon payment, interest-only loan, or negative amortization loan. See commentary to § 226.43(c)(5)(i) and (ii), which provides examples for calculating the monthly payment for purposes of the repayment ability determination required under § 226.43(c)(2)(iii).

2. *Greater of the fully indexed rate or introductory rate; premium adjustable-rate transactions.* A creditor must determine a consumer's repayment ability for the covered transaction using substantially equal, monthly, fully amortizing payments that are based on the greater of the fully indexed rate or any introductory interest rate. In some adjustable-rate transactions, creditors may set an initial interest rate that is not determined by the index or formula used to make later interest rate adjustments. Typically, this initial rate charged to consumers is lower than the rate would be if it were determined by using the the index plus margin, or formula (*i.e.,* fully indexed rate). However, an initial rate that is a

premium rate is higher than the rate based on the index or formula. In such cases, creditors must calculate the fully amortizing payment based on the initial "premium" rate. "Fully indexed rate" is defined in § 226.43(b)(3).

3. *Monthly, fully amortizing payments.* Section 226.43(c)(5)(i) does not prescribe the terms or loan features that a creditor may choose to offer or extend to a consumer, but establishes the calculation method a creditor must use to determine the consumer's repayment ability for a covered transaction. For example, the terms of the loan agreement may require that the consumer repay the loan in quarterly or bi-weekly scheduled payments, but for purposes of the repayment ability determination, the creditor must convert these scheduled payments to monthly payments in accordance with § 226.43(c)(5)(i)(B). Similarly, the loan agreement may not require the consumer to make fully amortizing payments, but for purposes of the repayment ability determination the creditor must convert any non-amortizing payments to fully amortizing payments.

4. *Substantially equal.* In determining whether monthly, fully amortizing payments are substantially equal, creditors should disregard minor variations due to payment-schedule irregularities and odd periods, such as a long or short first or last payment period. That is, monthly payments of principal and interest that repay the loan amount over the loan term need not be equal, but the monthly payments should be substantially the same without significant variation in the monthly combined payments of both principal and interest. For example, where no two monthly payments vary from each other by more than 1% (excluding odd periods, such as a long or short first or last payment period), such monthly payments would be considered substantially equal for purposes of this section. In general, creditors should determine whether the monthly, fully amortizing payments are substantially equal based on guidance provided in § 226.17(c)(3) (discussing minor variations), and § 226.17(c)(4)(i)–(iii) (discussing payment-schedule irregularities and measuring odd periods due to a long or short first period) and associated commentary.

5. *Examples.* The following are examples of how to determine the consumer's repayment ability based on substantially equal, monthly, fully amortizing payments as required under § 226.43(c)(5)(i) (all amounts are rounded):

i. *Fixed-rate mortgage.* A loan in an amount of $200,000 has a 30-year loan term and a fixed interest rate of 7%. For purposes of § 226.43(c)(2)(iii), the creditor must determine the consumer's ability to repay the loan based on a payment of $1,331, which is the substantially equal, monthly, fully amortizing payment that will repay $200,000 over 30 years using the fixed interest rate of 7%.

ii. *Adjustable-rate mortgage with discount for five years.* A loan in an amount of $200,000 has a 30-year loan term. The loan agreement provides for a discounted interest rate of 6% that is fixed for an initial period of five years, after which the interest rate will adjust annually based on a specified index plus a margin of 3%, subject to a 2% annual periodic interest rate adjustment cap. The index value in effect at consummation is 4.5%; the fully indexed rate is 7.5% (4.5% plus 3%). Even though the scheduled monthly payment required for the first five years is $1,199, for purposes of § 226.43(c)(2)(iii) the creditor must determine the consumer's ability to repay the loan based on a payment of $1,398, which is the substantially equal, monthly, fully amortizing payment that will repay $200,000 over 30 years using the fully indexed rate of 7.5%.

iii. *Step-rate mortgage.* A loan in an amount of $200,000 has a 30-year loan term. The loan agreement provides that the interest rate will be 6.5% for the first two years of the loan, 7% for the next three years of the loan, and 7.5% thereafter. Accordingly, the scheduled payment amounts are $1,264 for the first two years, $1,328 for the next three years, and $1,388 thereafter for the remainder of the term. For purposes of § 226.43(c)(2)(iii), the creditor must determine the consumer's ability to repay the loan based on a payment of $1,398, which is the substantially equal, monthly, fully amortizing payment that would repay $200,000 over 30 years using the fully indexed rate of 7.5%.

43(c)(5)(ii) Special rules for loans with a balloon payment, interest-only loans, and negative amortization loans.

Paragraph 43(c)(5)(ii)(A).

1. *General.* For loans with a balloon payment, the rules differ depending on whether the loan is a higher-priced covered transaction, as defined under § 226.43(b)(4), or is not a higher-priced covered transaction because the annual percentage rate does not exceed the applicable average prime offer rate (APOR) for a comparable transaction. "Average prime offer rate" is defined in § 226.45(a)(2)(ii); "higher-priced covered transaction" is defined in § 226.43(b)(4). For higher-priced covered transactions with a balloon payment, the creditor must consider the consumer's ability to repay the loan based on the payment schedule under the terms of the legal obligation, including any required balloon payment. For loans with a balloon payment that are not higher-priced covered transactions, the creditor should use the maximum payment scheduled during the first five years of the loan following consummation. "Balloon payment" is defined in § 226.18(s)(5)(i).

2. *First five years after consummation.* Under § 226.43(c)(5)(ii)(A)(*1*), the creditor must determine a consumer's ability to repay a loan with a balloon payment that is not a higher-priced covered transaction using the maximum payment scheduled during the first five years (60 months) after consummation. For example, assume a loan with a balloon payment due at the end of a five-year loan term. The loan is consummated on August 15, 2011, and the first monthly payment is due on October 1, 2011. The first five years after consummation occurs on August 15, 2016. The balloon payment must be made on the due date of the 60th monthly payment, which is September 1, 2016. For purposes of determining the consumer's ability to repay the loan under § 226.43(c)(2)(iii), the creditor need not consider the balloon payment that is due on September 1, 2016.

3. *Renewable balloon loan; loan term.* A balloon loan that is not a higher-priced covered transaction could provide that a creditor is unconditionally obligated to renew a balloon loan at the consumer's option (or is obligated to renew subject to conditions within the consumer's control). *See* comment 17(c)(1)–11 discussing renewable balloon loans. For purposes of this section, the loan term does not include any the period of time that could result from a renewal provision. To illustrate, assume a 3-year balloon loan that is not a higher-priced covered transaction contains an unconditional obligation to renew for another three years at the consumer's option. In this example, the loan term for the balloon loan is 3 years, and not the potential 6 years that could result if the consumer chooses to renew the loan. Accordingly, the creditor must underwrite the loan using the maximum payment scheduled in the first five years after consummation, which includes the balloon payment due at the end of the 3-year loan term. *See* comment 43(c)(5)(ii)(A).ii, which provides an example of how to determine the consumer's repayment ability for a 3-year renewable balloon loan.

4. *Examples of loans with a balloon payment that are not higher-priced covered transactions.* The following are examples of how to determine the maximum payment scheduled during the first five years after consummation (all amounts are rounded):

i. *Balloon payment loan with a three-year loan term; fixed interest rate.* A loan agreement provides for a fixed interest rate of 6%, which is below the APOR threshold for a comparable transaction, thus the loan is not a higher-priced covered transaction. The loan amount is $200,000, and the loan has a three-year loan term but is amortized over 30 years. The monthly payment scheduled for the first three years following consummation is $1,199, with a balloon payment of $193,367 due at the end of the third year. For purposes of § 226.43(c)(2)(iii), the creditor must determine the consumer's ability to repay the loan based on the balloon payment of $193,367.

ii. *Renewable balloon payment loan with a three-year loan term.* Assume the same facts above in 43(c)(5)(ii)(A).i, except that the loan agreement also provides that the creditor is unconditionally obligated to renew the balloon payment mortgage at the consumer's option at the end of the three-year term for another three years (the creditor retains the option to increase the interest rate at the time of renewal). In determining the maximum payment scheduled during the first five years after consummation, the creditor must use a loan term of three years. Accordingly, for purposes of § 226.43(c)(2)(iii), the creditor must determine the consumer's ability to repay the loan based on the balloon payment of $193,367.

iii. *Balloon payment loan with a five-year loan term; fixed interest rate.* A loan provides for a fixed interest rate of 6%, which is below the APOR threshold for a comparable transaction, and thus, the loan is not a higher-priced covered transaction. The loan amount is $200,000, and the loan has a five-year loan term but is amortized over 30 years. The loan is consummated on March 15, 2011, and the monthly payment scheduled for the first five years following consummation is $1,199, with the first monthly payment due on May 1, 2011. The first five years after consummation end on March 15, 2016. The balloon payment of $187,308 is required on the due date of the 60th monthly payment, which is April 1, 2016 (more than five years after consummation). For purposes of § 226.43(c)(2)(iii), the creditor must determine the consumer's ability to repay the loan based on the monthly payment of $1,199, and need not consider the balloon payment of $187,308 due on April 1, 2016.

5. *Example of a higher-priced covered transaction with a balloon payment.* The following is an example of how to determine the consumer's repayment ability based on the loan's payment schedule, including any balloon payment (all amounts are rounded):

i. *Balloon payment loan with a 10-year loan term; fixed interest rate.* The loan is a higher-priced covered transaction with a fixed interest rate of 7%. The loan amount is $200,000 and the loan has a 10-year loan term, but is amortized over 30 years. The monthly payment scheduled for the first ten years is $1,331, with a balloon payment of $172,956. For purposes of § 226.43(c)(2)(iii), the creditor must consider the consumer's ability to repay the loan based on the payment schedule that fully repays the loan amount, including the balloon payment of $172,956.

Paragraph 43(c)(5)(ii)(B).

1. *General.* For loans that permit interest-only payments, the creditor must use the fully indexed rate or introductory rate, whichever is greater, to calculate the substantially equal, monthly payment of principal and interest that will repay the loan amount over the term of the loan remaining as of the date the loan is recast. For discussion regarding the fully indexed rate and the meaning of "substantially equal," *see* comments 43(b)(3)–1 through –5 and 43(c)(5)(i)–4, respectively. Under § 226.43(c)(5)(ii)(B), the relevant term of the loan is the period of time that remains as of the date the loan is recast to require fully amortizing payments. For a loan on which only interest and no principal has been paid, the loan amount will be the outstanding principal balance at the time of the recast. "Loan amount" and "recast" are defined in § 226.43(b)(5) and (b)(11), respectively. "Interest-only" and "Interest-only loan" are defined in § 226.18(s)(7)(iv).

2. *Examples.* The following are examples of how to determine the consumer's repayment ability based on substantially equal, monthly payments of principal and interest under § 226.43(c)(5)(ii)(B) (all amounts are rounded):

i. *Fixed-rate mortgage with interest-only payments for five years.* A loan in an amount of $200,000 has a 30-year loan term. The loan agreement provides for a fixed interest rate of 7%, and permits interest-only payments for the first five years. The monthly payment of $1167 scheduled for the first five years would cover only the interest due. The loan is recast on the due date of the 60th monthly payment, after which the scheduled monthly payments increase to $1414, a monthly payment that repays the loan amount of $200,000 over the 25 years remaining as of the date the loan is recast (300 months). For purposes of § 226.43(c)(2)(iii), the creditor must determine the consumer's ability to repay the loan based on a payment of $1414, which is the substantially equal, monthly, fully amortizing payment that would repay $200,000 over the 25 years remaining as of the date the loan is recast using the fixed interest rate of 7%.

ii. *Adjustable-rate mortgage with discount for three years and interest-only payments for five years.* A loan in an amount of $200,000 has a 30-year loan term, but provides for interest-only payments for the first five years. The loan agreement provides for a discounted interest rate of 5% that is fixed for an initial period of three years, after which the interest rate will adjust each year based on a specified index plus a margin of 3%, subject to an annual interest rate adjustment cap of 2%. The index value in effect at consummation is 4.5%; the fully indexed rate is 7.5% (4.5% plus 3%). The monthly payments of $833 for the first three years and $1250 for the following two years would cover only the interest due. The loan is recast on the due date of the 60th monthly payment, after which the scheduled monthly payments increase to $1478, a monthly payment that will repay the loan amount of $200,000 over the remaining 25 years of the loan (300 months). For purposes of § 226.43(c)(2)(iii), the creditor must determine the consumer's ability to repay the loan based on a monthly payment of $1,478, which is the substantially equal, monthly payment of principal and interest that would repay $200,000 over the 25 years remaining as of the date the loan is recast using the fully indexed rate of 7.5%.

Paragraph 43(c)(5)(ii)(C).

1. *General.* For purposes of determining the consumer's ability to repay a negative amortization loan, the creditor must use substantially equal, monthly payments of principal and interest based on the fully indexed rate or the introductory rate, whichever is greater, that will repay the maximum loan amount over the term of the loan that remains as of the date the loan is recast. Accordingly, before determining the substantially equal, monthly payments the creditor must first determine the maximum loan amount and the period of time that remains in

the loan term after the loan is recast. "Recast" is defined in § 226.43(b)(11). Second, the creditor must use the fully indexed rate or introductory rate, whichever is greater, to calculate the substantially equal, monthly payment amount that will repay the maximum loan amount over the term of the loan remaining as of the date the loan is recast. For discussion regarding the fully indexed rate and the meaning of "substantially equal," see comments 43(b)(3)–1 through –5 and 43(c)(5)(i)–4, respectively. For the meaning of the term "maximum loan amount" and a discussion of how to determine the maximum loan amount for purposes of § 226.43(c)(5)(ii)(C), *see* § 226.43(b)(7) and associated commentary. "Negative amortization loan" is defined in § 226.18(s)(7)(v).

2. *Term of loan.* Under § 226.43(c)(5)(ii)(C), the relevant term of the loan is the period of time that remains as of the date the terms of the legal obligation recast. That is, the creditor must determine substantially equal, monthly payments of principal and interest that will repay the maximum loan amount based on the period of time that remains after any negative amortization cap is triggered or any period permitting minimum periodic payments expires, whichever occurs first.

3. *Examples.* The following are examples of how to determine the consumer's repayment ability based on substantially equal, monthly payments of principal and interest as required under § 226.43(c)(5)(ii)(C) (all amounts are rounded):

i. *Adjustable-rate mortgage with negative amortization.* A. Assume an adjustable-rate mortgage in the amount of $200,000 with a 30-year loan term. The loan agreement provides that the consumer can make minimum monthly payments that cover only part of the interest accrued each month until the date on which the principal balance reaches 115% of its original balance (*i.e.,* a negative amortization cap of 115%) or for the first five years of the loan (60 monthly payments), whichever occurs first. The introductory interest rate at consummation is 1.5%. One month after consummation, the interest rate adjusts and will adjust monthly thereafter based on the specified index plus a margin of 3.5%. The index value in effect at consummation is 4.5%; the fully indexed rate is 8% (4.5% plus 3.5%). The maximum lifetime interest rate is 10.5%; there are no other periodic interest rate adjustment caps that limit how quickly the maximum lifetime rate may be reached. The minimum monthly payment for the first year is based on the initial interest rate of 1.5%. After that, the minimum monthly payment adjusts annually, but may increase by no more than 7.5% over the previous year's payment. The minimum monthly payment is $690 in the first year, $742 in the second year, and $798 in the first part of the third year.

B. To determine the maximum loan amount, assume that the interest rate increases to the maximum lifetime interest rate of 10.5% at the first adjustment (*i.e.,* the second month), and interest accrues at that rate until the loan is recast. Assume that the consumer makes the minimum monthly payments scheduled, which are capped at 7.5% from year-to-year, for the maximum possible time. Because the consumer's minimum monthly payments are less than the interest accrued each month, negative amortization occurs (*i.e.,* the accrued but unpaid interest is added to the principal balance). Thus, assuming that the consumer makes the minimum monthly payments for as long as possible and that the maximum interest rate of 10.5% is reached at the first rate adjustment (*i.e.,* the second month), the negative amortization cap of 115% is reached on the due date of the 27th monthly payment and the loan is recast as of that date. The maximum loan amount as of the due date of the 27th monthly payment is $229,243, and the remaining term of the loan is 27 years and nine months (333 months).

C. For purposes of § 226.43(c)(2)(iii), the creditor must determine the consumer's ability to repay the loan based on a monthly payment of $1,716, which is the substantially equal, monthly payment of principal and interest that will repay the maximum loan amount of $229,243 over the remaining loan term of 333 months using the fully indexed rate of 8%. *See* comments 43(b)(7)–1 and –2 discussing the calculation of the maximum loan amount, and § 226.43(b)(11) for the meaning of the term "recast."

ii. *Fixed-rate, graduated payment mortgage.* A loan in the amount of $200,000 has a 30-year loan term. The loan agreement provides for a fixed-interest rate of 7.5%, and requires the consumer to make minimum monthly payments during the first year, with payments increasing 12.5% every year for four years (the annual payment cap). The payment schedule provides for payments of $943 in the first year, $1061 in the second year, $1194 in the third year, $1343 in the fourth year, and then requires $1511 for the remaining term of the loan. During the first three years of the loan, the payments are less than the interest accrued each month, resulting in negative amortization. Assuming the minimum payments increase year-to-year up to the 12.5% payment cap, the consumer will begin making payments that cover at least all of the interest accrued at the end of the third year. Thus, the loan is recast on the due date of the 36th monthly payment. The maximum loan amount on that date is $207,659, and the remaining loan term is 27 years (324 months). For purposes of § 226.43(c)(2)(iii), the creditor must determine the consumer's ability to repay the loan based on a monthly payment of $1497, which is the substantially equal, monthly payment of principal and interest that will repay the maximum loan amount of $207,659 over the remaining loan term of 27 years using the fixed interest rate of 7.5%.

43(c)(6) Payment calculation for simultaneous loans.

1. *Scope.* In determining the consumer's repayment ability for a covered transaction under § 226.43(c)(2)(iii), creditors must include consideration of any simultaneous loan which it knows, or has reason to know, will be made at or before consummation of the covered transaction. For a discussion of the standard "knows or has reason to know," see comment 43(c)(2)(iv)–2. For the meaning of the term "simultaneous loan," see § 226.43(b)(12).

2. *Payment calculation—covered transaction.* For a simultaneous loan that is a covered transaction, as that term is defined under § 226.43(b)(12), a creditor must determine a consumer's ability to repay the monthly payment obligation for a simultaneous loan as set forth in § 226.43(c)(5), taking into account any mortgage-related obligations. For the meaning of the term "mortgage-related obligations," see § 226.43(b)(8).

3. *Payment calculation—home equity line of credit.* For a simultaneous loan that is a home equity line of credit subject to § 226.5b, the creditor must consider the periodic payment required under the terms of the plan when assessing the consumer's ability to repay the covered transaction secured by the same dwelling as the simultaneous loan. Under § 226.43(c)(6)(ii), a creditor must determine the periodic payment required under the terms of the plan by considering the actual amount of credit to be drawn by the consumer at consummation of the covered transaction. The amount 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. For example, where

the creditor's policies and procedures require the source of downpayment to be verified, and the creditor verifies that a simultaneous loan that is a HELOC will provide the source of downpayment for the first-lien covered transaction, the creditor must consider the periodic payment on the HELOC by assuming the amount drawn is the downpayment amount. In general, a creditor should determine the periodic payment based on guidance in staff commentary to § 226.5b(d)(5) (discussing payment terms).

43(c)(7) Monthly debt-to-income ratio or residual income.

1. *Monthly debt-to-income ratio and monthly residual income.* Under § 226.43(c)(2)(vii), the creditor must consider the consumer's monthly debt-to-income ratio, or the consumer's monthly residual income, in accordance with the requirements in § 226.43(c)(7). To determine the appropriate threshold for the monthly debt-to-income ratio or the monthly residual income, the creditor may look to widely accepted governmental and non-governmental underwriting standards.

2. *Use of both debt-to-income ratio and monthly residual income.* If a creditor considers both the consumer's monthly debt-to-income ratio and the residual income, the creditor may base the ability-to-repay determination on either the consumer's debt-to-income ratio or residual income, even if the ability-to-repay determination would differ with the basis used.

3. *Compensating factors.* The creditor may consider compensating factors to mitigate a higher debt-to-income ratio or lower residual income. For example, the creditor may consider the consumer's assets other than the dwelling securing the covered transaction or the consumer's residual income as a compensating factor for a higher debt-to-income ratio. In determining whether and in what manner to consider compensating factors, creditors may look to widely accepted governmental and non-governmental underwriting standards.

43(d) Refinancing of non-standard mortgages.

43(d)(1) Scope.

1. *Written application.* For an explanation of the requirements for a "written application" in § 226.43(d)(1)(iii), (d)(1)(iv) and (d)(1)(v), see comment 19(a)(1)(i)–3.

Paragraph 43(d)(1)(ii).

1. *Materially lower.* The exemptions afforded under § 226.43(d)(3) apply to a refinancing only if the monthly payment for the new loan is "materially lower" than the monthly payment for an existing non-standard mortgage. The payments to be compared must be calculated based on the requirements under § 226.43(d)(5). Whether the new loan payment is "materially lower" than the non-standard mortgage payment depends on the facts and circumstances. In all cases, a payment reduction of 10 percent or more meets the "materially lower" standard.

Paragraph 43(d)(1)(iv).

1. *Late payment—24 months prior to application.* Under § 226.43(d)(1)(iv), the exemptions in § 226.43(d)(3) apply to a covered transaction only if, during the 24 months immediately preceding the creditor's receipt of the consumer's written application for a refinancing, the consumer has made no more than one payment on the non-standard mortgage more than 30 days late. (For an explanation of "written application," see comment 43(d)(1)–1.) For example, assume a consumer applies for a refinancing on May 1, 2011. Assume also that the consumer made a non-standard mortgage payment on August 15, 2009, that was 45 days late. The consumer made no other late payments on the non-standard mortgage between May 1, 2009, and May 1, 2011. In this example, the requirement under § 226.43(d)(1)(iv) is met because the consumer made only one payment that was over 30 days late within the 24 months prior to applying for the refinancing (*i.e.,* 20 and one-half months prior to application).

2. *Payment due date.* Whether a payment is more than 30 days late is measured in relation to the contractual due date not accounting for any grace period. For example, if the contractual due date for a non-standard mortgage payment is the first day of every month, but no late fee will be charged as long as the payment is received by the 16th of the month, the payment due date for purposes of § 226.43(d)(1)(iv) and (d)(1)(v) is the first day of the month, not the 16th day of the month. Thus, a payment due under the contract on September 1st that is paid on October 1st is made more than 30 days after the payment due date.

Paragraph 43(d)(1)(v).

1. *Late payment—six months prior to application.* Under § 226.43(d)(1)(v), the exemptions in § 226.43(d)(3) apply to a covered transaction only if, during the six months immediately preceding the creditor's receipt of the consumer's written application for a refinancing, the consumer has made no payments on the non-standard mortgage more than 30 days late. (For an explanation of "written application" and how to determine the payment due date, see comments 43(d)(1)–1 and 43(d)(1)(iv)–2.) For example, assume a consumer with a non-standard mortgage applies for a refinancing on May 1, 2011. If the consumer made a 45-day late payment on March 15, 2011, the requirement under § 226.43(d)(1)(v) is not met because the consumer made a payment more than 30 days late just one and one-half months prior to application. If the number of months between consummation of the non-standard mortgage and the consumer's application for the standard mortgage is six or fewer, the consumer may not have made any payment more than 30 days late on the non-standard mortgage.

43(d)(2) Definitions.

43(d)(2)(i) Non-standard mortgage.

Paragraph 43(d)(2)(i)(A).

1. *Adjustable-rate mortgage with an introductory fixed rate.* Under § 226.43(d)(2)(i)(A), an adjustable-rate mortgage with an introductory fixed interest rate for one year or longer is considered a "non-standard mortgage." For example, a covered transaction that has a fixed introductory rate for the first two, three or five years and then converts to a variable rate for the remaining 28, 27 or 25 years, respectively, is a "non-standard mortgage." A covered transaction with an introductory rate for six months that then converts to a variable rate for the remaining 29 and ½ years is not a "non-standard mortgage."

43(d)(2)(ii) Standard mortgage.

Paragraph 43(d)(2)(ii)(A).

1. *Regular periodic payments.* Under § 226.43(d)(2)(ii)(A), a "standard mortgage" must provide for regular periodic payments that do not result in an increase of the principal balance (negative amortization), allow the consumer to defer repayment of principal (*see* comment 43(e)(2)(i)–2), or result in a balloon payment. Thus, the terms of the legal obligation must require the consumer to make payments of principal and interest on a monthly or other periodic basis that will repay the loan amount over the loan term. Except for payments resulting from any interest rate changes after consummation in an adjustable-rate or step-rate mortgage, the periodic payments must be substantially equal. For an explanation of the term "substantially equal," see comment 43(c)(5)(i)–4. In addition, a single-payment transaction is not a "standard mortgage" because it does not require "regular periodic payments." *See also* comment 43(e)(2)(i)–1.

Paragraph 43(d)(2)(ii)(D).

1. *First five years after consummation.* A "standard mortgage" must have an interest rate that is fixed for at least the first five years (60 months) after consummation. For example, assume an

adjustable-rate mortgage that applies the same fixed interest rate to determine the first 60 payments of principal and interest due. The loan consummates on August 15, 2011, and the first monthly payment is due on October 1, 2011. The first five years after consummation occurs on August 15, 2016. The first interest rate adjustment occurs on the due date of the 60th monthly payment, which is September 1, 2016. This loan meets the criterion for a "standard mortgage" under § 226.43(d)(2)(ii)(D) because the interest rate is fixed until September 1, 2016, which is more than five years after consummation. For guidance regarding step-rate mortgages, see comment 43(e)(2)(iv)–3.iii.

Paragraph 43(d)(2)(ii)(E).

1. *Permissible use of proceeds.* To qualify as a "standard mortgage," the mortgage proceeds may be used for only two purposes: paying off the non-standard mortgage and paying for closing costs, including paying escrow amounts required at or before closing. If the proceeds of a covered transaction are used for other purposes, such as to pay off other liens or to provide additional cash to the consumer for discretionary spending, the transaction does not meet the definition of a "standard mortgage."

43(d)(3) Exemption from certain repayment ability requirements.

Paragraph 43(d)(3)(i).

1. *Two-part determination.* To qualify for the exemptions in § 226.43(d)(3), a creditor must have considered, first, whether the consumer is likely to default on the existing mortgage once that loan is recast, and second, whether the new mortgage will prevent the consumer's default.

2. *Likely default.* In considering whether a consumer is likely to default on the standard mortgage once it is recast, a creditor may look to widely-accepted governmental and non-governmental standards for analyzing a consumer's likelihood of default.

Paragraph 43(d)(3)(ii).

1. *Payment calculation for repayment ability requirements.* If the conditions in § 226.43(d)(3)(i) are met, the creditor may meet the payment calculation requirements for determining a consumer's ability to repay the new loan by applying the calculation prescribed under § 226.43(d)(5)(ii), rather than the calculations prescribed under § 226.43(c)(2)(iii) and (c)(5). For example, assume that a "standard mortgage" is an adjustable-rate mortgage that has an initial fixed interest rate for the first five years after consummation. The loan consummates on August 15, 2011, and the first monthly payment is due on October 1, 2011. Five years after consummation occurs on August 15, 2016. The first interest rate adjustment occurs on the due date of the 60th monthly payment, which is September 1, 2016. Under § 226.43(d)(3)(ii), to calculate the payment required for the ability-to-repay rule under § 226.43(c)(2)(iii), the creditor should use the payment based on the interest rate that is fixed for the first five years after consummation (from August 15, 2011, until August 15, 2016), and is not required to account for the payment resulting after the first interest rate adjustment on September 1, 2016.

43(d)(5) Payment calculations.

43(d)(5)(i) Non-standard mortgage.

1. *Payment calculation for a non-standard mortgage.* In determining whether the monthly periodic payment for a standard mortgage is materially lower than the monthly periodic payment for the non-standard mortgage under § 226.43(d)(1)(ii), the creditor must consider the monthly payment for the non-standard mortgage that will result after the loan is "recast," assuming substantially equal payments of principal and interest that amortize the remaining loan amount over the remaining term as of the date the mortgage is recast. For guidance regarding the meaning of "substantially equal," see comment 43(c)(5)(i)–4. For the meaning of "recast," see § 226.43(b)(11) and associated commentary.

2. *Fully indexed rate.* The term "fully indexed rate" in § 226.43(d)(5)(i)(A) for calculating the payment for a non-standard mortgage is generally defined in § 226.43(b)(3) and associated commentary. Under § 226.43(b)(3) the fully indexed rate is calculated at the time of consummation. For purposes of § 226.43(d)(5)(i), however, the fully indexed rate is calculated within a reasonable period of time before or after the date the creditor receives the consumer's written application for the standard mortgage. Thirty days is generally considered "a reasonable period of time."

3. *Written application.* For an explanation of the requirements for a "written application" in § 226.43(d)(5)(i), see comment 19(a)(1)(i)–3.

4. *Payment calculation for an adjustable-rate mortgage with an introductory fixed rate.* Under § 226.43(d)(5)(i), the monthly periodic payment for an adjustable-rate mortgage with an introductory fixed interest rate for a period of one or more years must be calculated based on several assumptions.

i. First, the payment must be based on the outstanding principal balance as of the date on which the mortgage is recast, assuming all scheduled payments have been made up to that date and the last payment due under those terms is made and credited on that date. For example, assume an adjustable-rate mortgage with a 30-year loan term. The loan agreement provides that the payments for the first 24 months are based on a fixed rate, after which the interest rate will adjust annually based on a specified index and margin. The loan is recast on the due date of the 24th payment. If the 24th payment is due on September 1, 2013, the creditor must calculate the outstanding principal balance as of September 1, 2013, assuming that all 24 payments under the fixed rate terms have been made and credited timely.

ii. Second, the payment calculation must be based on substantially equal monthly payments of principal and interest that will fully repay the outstanding principal balance over the term of the loan remaining as of the date the loan is recast. Thus, in the example above, the creditor must assume a loan term of 28 years (336 payments).

iii. Third, the payment must be based on the fully indexed rate, as defined in § 226.43(b)(3), as of the date of the written application for the standard mortgage.

5. *Example of payment calculation for an adjustable-rate mortgage with an introductory fixed rate.* The following example illustrates the rule described in comment 43(d)(5)(i)–4:

i. A loan in an amount of $200,000 has a 30-year loan term. The loan agreement provides for a discounted introductory interest rate of 5% that is fixed for an initial period of two years, after which the interest rate will adjust annually based on a specified index plus a margin of 3 percentage points.

ii. The non-standard mortgage consummates on February 15, 2011, and the first monthly payment is due on April 1, 2011. The loan is recast on the due date of the 24th monthly payment, which is March 1, 2013.

iii. On March 15, 2012, the creditor receives the consumer's written application for a refinancing after the consumer has made 12 monthly on-time payments. On this date, the index value is 4.5%.

iv. To calculate the non-standard mortgage payment that must be compared to the standard mortgage payment under § 226.43(d)(1)(ii), the creditor must use—

A. The outstanding principal balance as of March 1, 2013, assuming all scheduled payments have been made up to March 1, 2013, and the last payment due under the fixed rate terms is made and credited on March 1, 2013. In this example, the outstanding principal balance is $193,948.

B. The fully indexed rate of 7.5%, which is the index value of 4.5% as of March 15, 2012 (the date on which the application for a refinancing is received) plus the margin of 3%.

C. The remaining loan term as of March 1, 2013, the date of the recast, which is 28 years (336 payments).

v. Based on these assumptions, the monthly payment for the non-standard mortgage for purposes of determining whether the standard mortgage monthly payment is lower than the non-standard mortgage monthly payment (*see* § 226.43(d)(1)(ii)) is $1,383. This is the substantially equal, monthly payment of principal and interest required to repay the outstanding principal balance at the fully-indexed rate over the remaining term.

6. *Payment calculation for an interest-only loan.* Under § 226.43(d)(5)(i), the monthly periodic payment for an interest-only loan must be calculated based on several assumptions.

i. First, the payment must be based on the loan amount, as defined in § 226.43(b)(5) (for a loan on which only interest and no principal has been paid, the "loan amount" will be the outstanding principal balance at the time of the recast), assuming all scheduled payments are made under the terms of the legal obligation in effect before the mortgage is recast. For example, assume that a mortgage has a 30-year loan term, and provides that the first 24 months of payments are interest-only. If the 24th payment is due on September 1, 2013, the creditor must calculate the outstanding principal balance as of September 1, 2013, assuming that all 24 payments under the interest-only payment terms have been made and credited timely.

ii. Second, the payment calculation must be based on substantially equal monthly payments of principal and interest that will fully repay the loan amount over the term of the loan remaining as of the date the loan is recast. Thus, in the example above, the creditor must assume a loan term of 28 years (336 payments).

iii. Third, the payment must be based on the fully indexed rate, as defined in § 226.43(b)(3), as of the date of the written application for the standard mortgage.

7. *Example of payment calculation for an interest-only loan.* The following example illustrates the rule described in comment 43(d)(5)(i)–6:

i. A loan in an amount of $200,000 has a 30-year loan term. The loan agreement provides for a fixed interest rate of 7%, and permits interest-only payments for the first two years (the first 24 payments), after which time amortizing payments of principal and interest are required.

ii. The non-standard mortgage consummates on February 15, 2011, and the first monthly payment is due on April 1, 2011. The loan is recast on the due date of the 24th monthly payment, which is March 1, 2013.

iii. On March 15, 2012, the creditor receives the consumer's written application for a refinancing, after the consumer has made 12 monthly on-time payments.

iv. To calculate the non-standard mortgage payment that must be compared to the standard mortgage payment under § 226.43(d)(1)(ii), the creditor must use—

A. The loan amount, which is the outstanding principal balance as of March 1, 2013, assuming all scheduled interest-only payments have been made and credited up to that date. In this example, the loan amount is $200,000.

B. An interest rate of 7%, which is the interest rate in effect at the time of consummation of this fixed-rate non-standard mortgage.

C. The remaining loan term as of March 1, 2013, the date of the recast, which is 28 years (336 payments).

v. Based on these assumptions, the monthly payment for the non-standard mortgage for purposes of determining whether the standard mortgage monthly payment is lower than the non-standard mortgage monthly payment (*see* § 226.43(d)(1)(ii)) is $1,359. This is the substantially equal, monthly payment of principal and interest required to repay the loan amount at the fully-indexed rate over the remaining term.

8. *Payment calculation for a negative amortization loan.* Under § 226.43(d)(5)(i), the monthly periodic payment for a negative amortization loan must be calculated based on several assumptions.

i. First, the calculation must be based on the maximum loan amount, as defined in § 226.43(b)(7). For examples of how to calculate the maximum loan amount, see comment 43(b)(7)–3.

ii. Second, the calculation must be based on substantially equal monthly payments of principal and interest that will fully repay the maximum loan amount over the term of the loan remaining as of the date the loan is recast. For example, if the loan term is 30 years and the loan is recast on the due date of the 60th monthly payment, the creditor must assume a loan term of 25 years (300 payments).

iii. Third, the payment must be based on the fully-indexed rate as of the date of the written application for the standard mortgage.

9. *Example of payment calculation for a negative amortization loan.* The following example illustrates the rule described in comment 43(d)(5)(i)–8:

i. A loan in an amount of $200,000 has a 30-year loan term. The loan agreement provides that the consumer can make minimum monthly payments that cover only part of the interest accrued each month until the date on which the principal balance increases to the negative amortization cap of 115% of the loan amount, or for the first five years of monthly payments (60 payments), whichever occurs first. The loan is an adjustable-rate mortgage that adjusts monthly according to a specified index plus a margin of 3.5%.

ii. The non-standard mortgage consummates on February 15, 2011, and the first monthly payment is due on April 1, 2011. Assume that, based on the calculation of the maximum loan amount required under § 226.43(b)(7) and associated commentary, the negative amortization cap of 115% would be reached on July 1, 2013, the due date of the 28th monthly payment.

iii. On March 15, 2012, the creditor receives the consumer's written application for a refinancing, after the consumer has made 12 monthly on-time payments. On this date, the index value is 4.5%.

iv. To calculate the non-standard mortgage payment that must be compared to the standard mortgage payment under § 226.43(d)(1)(ii), the creditor must use—

A. The maximum loan amount of $229,243 as of July 1, 2013.

B. The fully indexed rate of 8%, which is the index value of 4.5% as of March 15, 2012 (the date on which the creditor receives the application for a refinancing) plus the margin of 3.5%.

C. The remaining loan term as of July 1, 2013, the date of the recast, which is 27 years and eight months (332 monthly payments).

v. Based on these assumptions, the monthly payment for the non-standard mortgage for purposes of determining whether the standard mortgage monthly payment is lower than the non-standard mortgage monthly payment (*see* § 226.43(d)(1)(ii)) is $1,717. This is the substantially equal, monthly payment of principal and interest required to repay the maximum loan amount at the fully-indexed rate over the remaining term.

43(d)(5)(ii) Standard mortgage.

1. *Payment calculation for a standard mortgage.* In determining whether the monthly periodic payment for a standard mortgage is materially lower than the monthly periodic payment for

a non-standard mortgage, the creditor must consider the monthly payment for the standard mortgage that will result in substantially equal, monthly, fully amortizing payments (as defined in § 226.43(b)(2)) using the rate as of consummation. For guidance regarding the meaning of "substantially equal" see comment 43(c)(5)(i)–4. For a mortgage with a single, fixed rate for the first five years, the maximum rate that will apply during the first five years after consummation will be the rate at consummation. For a step-rate mortgage, however, which is a type of fixed-rate mortgage, the rate that must be used is the highest rate that will apply during the first five years after consummation. For example, if the rate for the first two years is 4%, the rate for the second two years is 5%, and the rate for the next two years is 6%, the rate that must be used is 6%.

2. *Example of payment calculation for a standard mortgage.* The following example illustrates the rule described in comment 43(d)(5)(ii)–1: A loan in an amount of $200,000 has a 30-year loan term. The loan agreement provides for a discounted interest rate of 6% that is fixed for an initial period of five years, after which time the interest rate will adjust annually based on a specified index plus a margin of 3%, subject to a 2% annual interest rate adjustment cap. The creditor must determine whether the standard mortgage monthly payment is materially lower than the non-standard mortgage monthly payment (*see* § 226.43(d)(1)(ii)) based on a standard mortgage payment of $1,199. This is the substantially equal, monthly payment of principal and interest required to repay $200,000 over 30 years at an interest rate of 6%.

43(e) Presumption of compliance for qualified mortgages.

Alternative 1—Paragraph 43(e)(1)–1

43(e)(1) Safe harbor.

1. *In general.* A creditor or assignee that satisfies the requirements of § 226.43(e)(2) or § 226.43(f), as applicable, is deemed to have complied with § 226.43(c)(1). That is, a creditor or assignee need not demonstrate compliance with § 226.43(c)(2)–(7) if the terms of the loan comply with § 226.43(e)(2)(i)–(ii) (or, if applicable, § 226.43(f)); the loan's points and fees do not exceed the limits set forth in § 226.43(e)(2)(iii); and the creditor has complied with the underwriting criteria described in § 226.43(e)(2)(iv)–(v) (or, if applicable, § 226.43(f)). The consumer may show the loan is not a qualified mortgage with evidence that the terms, points and fees, or underwriting did not comply with § 226.43(e)(2)(i)–(v) (or § 226.43(f), if applicable). If a loan is not a qualified mortgage (for example because the loan provides for negative amortization), then the creditor or assignee must demonstrate that the loan complies with all of the requirements in § 226.43(c) (or, if applicable, § 226.43(d)).

Alternative 2—Paragraph 43(e)(1)–1

43(e)(1) Presumption of compliance.

1. *In general.* Under § 226.43(c)(1), a creditor must make a reasonable and good faith determination at or before consummation that the consumer will have a reasonable ability, at the time of consummation, to repay the loan according to its terms, including any mortgage-related obligations. Under § 226.43(e)(1), a creditor or assignee of a covered transaction is presumed to have complied with the repayment ability requirement of § 226.43(c)(1) if the terms of the loan comply with § 226.43(e)(2)(i)–(ii) (or, if applicable, § 226.43(f)); the points and fees do not exceed the limit set forth in § 226.43(e)(2)(iii), and the creditor has complied with the underwriting criteria described in § 226.43(e)(2)(iv)–(v) (or, if applicable, § 226.43(f)). If a loan is not a qualified mortgage (for example because the loan provides for negative amortization), then the creditor or assignee must demonstrate that the loan complies with all of the requirements in § 226.43(c) (or, if applicable, § 226.43(d)). However, even if the loan is a qualified mortgage, the consumer may rebut the presumption of compliance with evidence that the loan did not comply with § 226.43(c)(1). For example, evidence of a high debt-to-income ratio with no compensating factors, such as adequate residual income, could be sufficient to rebut the presumption.

43(e)(2) Qualified mortgage defined.

Paragraph 43(e)(2)(i).

1. *Regular periodic payments.* Under § 226.43(e)(2)(i), a qualified mortgage must provide for regular periodic payments that may not result in an increase of the principal balance (negative amortization), deferral of principal repayment, or a balloon payment. Thus, the terms of the legal obligation must require the consumer to make payments of principal and interest, on a monthly or other periodic basis, that will fully repay the loan amount over the loan term. The periodic payments must be substantially equal except for the effect that any interest rate change after consummation has on the payment in the case of an adjustable-rate or step-rate mortgage. In addition, because § 226.43(e)(2)(i) requires that a qualified mortgage provide for regular periodic payments, a single-payment transaction may not be a qualified mortgage.

2. *Deferral of principal repayment.* Under § 226.43(e)(2)(i)(B), a qualified mortgage's regular periodic payments may not allow the consumer to defer repayment of principal, except as provided in § 226.43(f). A loan allows the deferral of principal repayment if one or more of the periodic payments may be applied solely to accrued interest and not to loan principal. Deferred principal repayment also occurs if the payment is applied to both accrued interest and principal but the consumer is permitted to make periodic payments that are less than the amount that would be required under a payment schedule that has substantially equal payments that fully repay the loan amount over the loan term. Graduated payment mortgages, for example, allow deferral of principal repayment in this manner and therefore may not be qualified mortgages.

Paragraph 43(e)(2)(iv).

1. *Maximum interest rate during the first five years after consummation.* For a qualified mortgage, the creditor must underwrite the loan using a periodic payment of principal and interest based on the maximum interest rate that may apply during the first five years after consummation. Creditors must use the maximum rate that could apply at any time during the first five years after consummation, regardless of whether the maximum rate is reached at the first or subsequent adjustment during the five year period.

2. *Fixed-rate mortgage.* For a fixed-rate mortgage, creditors should use the interest rate in effect at consummation. "Fixed-rate mortgage" is defined in § 226.18(s)(7)(iii).

3. *Interest rate adjustment caps.* For an adjustable-rate mortgage, creditors should assume the interest rate increases after consummation as rapidly as possible, taking into account the terms of the legal obligation. That is, creditors should account for any periodic interest rate adjustment cap that may limit how quickly the interest rate can increase under the terms of the legal obligation. Where a range for the maximum interest rate during the first five years is provided, the highest rate in that range is the maximum interest rate for purposes of this section. Where the terms of the legal obligation are not based on an index plus margin or formula, the creditor must use the maximum interest rate that occurs during the first five years after consummation. To illustrate:

i. *Adjustable-rate mortgage with discount for three years.* Assume an adjustable-rate mortgage has an initial discounted rate of 5% that is fixed for the first three years of the loan, after which the rate will adjust annually based on a specified index plus a margin of 3%. The index value in effect at consummation is 4.5%. The loan agreement provides for an annual interest rate adjustment cap of 2%, and a lifetime maximum interest rate of 10%. The first rate adjustment occurs on the due date of the 36th monthly payment; the rate can adjust to no more than 7% (5% initial discounted rate plus 2% annual interest rate adjustment cap). The second rate adjustment occurs on the due date of the 48th monthly payment; the rate can adjust to no more than 9% (7% rate plus 2% annual interest rate adjustment cap). The third rate adjustment occurs on the due date of the 60th monthly payment, which occurs more than five years after consummation. The maximum interest rate during the first five years after consummation is 9% (the rate on the due date of the 48th monthly payment). For further discussion of how to determine whether a rate adjustment occurs during the first five years after consummation, *see* comment 43(e)(2)(iv)-2.

ii. *Adjustable-rate mortgage with discount for three years.* Assume the same facts above except that the lifetime maximum interest rate is 8%, which is less than the maximum interest rate in the first five years of 9%. The maximum interest rate during the first five years after consummation is 8%.

iii. *Step-rate mortgage.* Assume a step-rate mortgage with an interest rate fixed at 6.5% for the first two years, 7% for the next three years, and then 7.5% for remainder of the loan term. The maximum interest rate during the first five years after consummation is 7%.

4. *First five years after consummation.* Under § 226.43(e)(2)(iv)(A), the creditor must underwrite the loan using the maximum interest rate that may apply during the first five years after consummation. To illustrate, assume an adjustable-rate mortgage with an initial fixed interest rate of 5% for the first five years after consummation, after which the interest rate will adjust annually to the specified index plus a margin of 6%, subject to a 2% annual interest rate adjustment cap. The index value in effect at consummation is 5.5%. The loan consummates on September 15, 2011, and the first monthly payment is due on November 1, 2011. The first five years after consummation occurs on September 15, 2016. The first rate adjustment to no more than 7% (5% plus 2% annual interest rate adjustment cap) occurs on the due date of the 60th monthly payment, which is October 1, 2016, and therefore, the rate adjustment does not occur during the first five years after consummation. To meet the definition of qualified mortgage under § 226.43(e)(2), the creditor must underwrite the loan using a monthly payment of principal and interest based on an interest rate of 5%, which is the maximum interest rate during the first five years after consummation.

5. *Loan amount.* To meet the definition of qualified mortgage under § 226.43(e)(2), a creditor must determine the periodic payment of principal and interest using the maximum interest rate permitted during the first five years after consummation that repays either—

i. The outstanding principal balance as of the earliest date the maximum interest rate during the first five years after consummation can take effect under the terms of the legal obligation, over the remaining term of the loan. To illustrate, assume a loan in an amount of $200,000 has a 30-year loan term. The loan agreement provides for a discounted interest rate of 5% that is fixed for an initial period of three years, after which the interest rate will adjust annually based on a specified index plus a margin of 3%, subject to a 2% annual interest rate adjustment cap and a lifetime maximum interest rate of 10%. The index value in effect at consummation equals 4.5%. Assuming the interest rate increases after consummation as quickly as possible, the rate adjustment to the maximum interest rate of 9% occurs on the due date of the 48th monthly payment. The outstanding principal balance on the loan at the end of the fourth year (after the 48th monthly payment is credited) is $188,218. The creditor will meet the definition of qualified mortgage if it underwrites the covered transaction using the monthly payment of principal and interest of $1,564 to repay the outstanding principal balance of $188,218 over the remaining 26 years of the loan term (312 months) using the maximum interest rate during the first five years of 9%; or

ii. The loan amount, as that term is defined in § 226.43(b)(5), over the entire loan term, as that term is defined in § 226.43(b)(6). Using the same example above, the creditor will meet the definition of qualified mortgage if it underwrites the covered transaction using the monthly payment of principal and interest of $1,609 to repay the loan amount of $200,000 over the 30-year loan term using the maximum interest rate during the first five years of 9%.

6. *Mortgage-related obligations.* Section 226.43(e)(2)(iv) requires creditors to take mortgage-related obligations into account when underwriting the loan. For the meaning of the term "mortgage-related obligations," see § 226.43(b)(8) and associated commentary.

7. *Examples.* The following are examples of how to determine the periodic payment of principal and interest based on the maximum interest rate during the first five years after consummation for purposes of meeting the definition of qualified mortgage under § 226.43(e) (all payment amounts are rounded):

i. *Fixed-rate mortgage.* A loan in an amount of $200,000 has a 30-year loan term and a fixed interest rate of 7%. The maximum interest rate during the first five years after consummation for a fixed-rate mortgage is the interest rate in effect at consummation, which is 7% under this example. The monthly fully amortizing payment scheduled over the 30 years is $1,331. The creditor will meet the definition of qualified mortgage if it underwrites the loan using the fully amortizing payment of $1,331.

ii. *Adjustable-rate mortgage with discount for three years.*

A. A loan in an amount of $200,000 has a 30-year loan term. The loan agreement provides for a discounted interest rate of 5% that is fixed for an initial period of three years, after which the interest rate will adjust annually based on a specified index plus a margin of 3%, subject to a 2% annual interest rate adjustment cap. The index value in effect at consummation is 4.5%. The loan consummates on March 15, 2011, and the first regular periodic payment is due May 1, 2011. The loan agreement provides that the first rate adjustment occurs on April 1, 2014 (the due date of the 36th monthly payment); the second rate adjustment occurs on April 1, 2015 (the due date of the 48th monthly payment); and the third rate adjustment occurs on April 1, 2016 (the due date of the 60th monthly payment), which occurs more than five years after consummation of the loan. Under this example, the maximum interest rate during the first five years after consummation is 9%, which applies beginning on April 1, 2015 (the due date of the 48th monthly payment). The outstanding principal balance at the end of the fourth year (after the 48th payment is credited) is $188,218.

B. The creditor will meet the definition of a qualified mortgage if it underwrites the loan using the monthly payment of principal and interest of $1,564 to repay the outstanding principal balance at the end of the fourth year of $188,218 over the remaining 26 years of the loan term (312 months), using the maximum interest rate during the first five years after consummation of 9%. Alternatively, the creditor will meet the definition of a qualified mortgage if it underwrites the loan using the monthly payment of principal and interest of $1,609 to repay the loan amount of $200,000 over the 30-year loan term, using the maximum interest rate during the first five years after consummation of 9%.

iii. *Adjustable-rate mortgage with discount for five years.*

A. A loan in an amount of $200,000 has a 30-year loan term. The loan agreement provides for a discounted interest rate of 6% that is fixed for an initial period of five years, after which the interest rate will adjust annually based on a specified index plus a margin of 3%, subject to a 2% annual interest rate adjustment cap. The index value in effect at consummation is 4.5%. The loan consummates on March 15, 2011 and the first regular periodic payment is due May 1, 2011. Under the terms of the loan agreement, the first rate adjustment is on April 1, 2016 (the due date of the 60th monthly payment), which occurs more than five years after consummation of the loan. Thus, the maximum interest rate under the terms of the loan during the first five years after consummation is 6%.

B. The creditor will meet the definition of a qualified mortgage if it underwrites the loan using the monthly payment of principal and interest of $1,199 to repay the loan amount of $200,000 over the 30-year loan term using the maximum interest rate during the first five years of 6%.

iv. *Step-rate mortgage.* A. A loan in an amount of $200,000 has a 30-year loan term. The loan agreement provides that the interest rate is 6.5% for the first two years of the loan, 7% for the next three years, and then 7.5% for remainder of the loan term. The maximum interest rate during the first five years after consummation is 7%, which occurs on the due date of the 24th monthly payment. The outstanding principal balance at the end of the second year (after the 24th payment is credited) is $195,379.

B. The creditor will meet the definition of a qualified mortgage if it underwrites the loan using a monthly payment of principal and interest of $1,328 to repay the outstanding principal balance of $195,379 over the remaining 28 years of the loan term (336 months), using the maximum interest rate during the first five years of 7%. Alternatively, the creditor will meet the definition of a qualified mortgage if it underwrites the loan using a monthly payment of principal and interest of $1,331 to repay $200,000 over the 30-year loan term using the maximum interest rate during the first five years of 7%.

Alternative 1—Paragraph 43(e)(2)(v)

Paragraph 43(e)(2)(v).

1. *Income or assets.* Creditors may rely on commentary to § 226.43(c)(2)(i), (c)(3), and (c)(4) for guidance regarding considering and verifying the consumer's income or assets to satisfy the conditions under § 226.43(e)(2)(v) for a "qualified mortgage."

Alternative 2—Paragraph 43(e)(2)(v)

Paragraph 43(e)(2)(v).

1. *Repayment ability.* Creditors may rely on commentary to § 226.43(c)(2)(i), (ii), (iv), and (vi) through (viii), (c)(3), (c)(4), (c)(6), and (c)(7) for guidance regarding considering and verifying the consumer's repayment ability to satisfy the conditions under § 226.43(e)(2)(v) for a "qualified mortgage."

43(e)(3) Limits on points and fees for qualified mortgages.

Paragraph 43(e)(3)(i).

1. *Total loan amount.* For an explanation of how to calculate the "total loan amount" under § 226.43(e)(3)(i), see comment 32(a)(1)(ii)-1.

2. *Calculation of allowable points and fees.* A creditor must determine which category the loan falls into based on the face amount of the note (the "loan amount"), but must apply the allowable points and fees percentage to the "total loan amount," which may be different than the face amount of the note. A creditor must calculate the allowable amount of points and fees for a qualified mortgage as follows:

i. First, the creditor must determine the "tier" into which the loan falls based on the loan amount. The loan amount is the principal amount the consumer will borrow as reflected in the promissory note or loan contract. *See* § 226.43(b)(5). For example, if the loan amount is $75,000, the loan falls into the tier for loans of $75,000 or more, to which a three percent cap on points and fees applies.

ii. Second, the creditor must determine the "total loan amount" based on the calculation for the "total loan amount" under comment 32(a)(1)(ii)–1. If the loan amount is $75,000, for example, the "total loan amount" may be a different amount, such as $73,000.

iii. Third, the creditor must apply the percentage cap on points and fees to the "total loan amount." For example, for a loan of $75,000 where the "total loan amount" is $73,000, the allowable points and fees is three percent of $73,000 or $2,190.

Alternative 1—Comment 43(e)(3)(i)–3

3. *Sample determination of allowable points and fees for a $50,000 loan.* A covered transaction with a loan amount of $50,000 falls into the third points and fees tier, to which a points and fees cap of 3.5 percent of the total loan amount applies. *See* § 226.43(e)(3)(i)(C). If a $48,000 total loan amount is assumed, the allowable points and fees for this $50,000 loan is 3.5 percent of $48,000 or $1,920.

Alternative 2—Comment 43(e)(3)(i)–3

3. *Sample determination of allowable points and fees for a $50,000 loan.* A covered transaction with a loan amount of $50,000 falls into the second points and fees tier, requiring application of a formula to derive the allowable points and fees. *See* § 226.43(e)(3)(i)(B). If a $48,000 total loan amount is assumed, the required formula must be applied as follows:

i. First, the amount of $20,000 must be subtracted from $48,000 to yield the number of dollars to which the .0036 basis points multiple must be applied—in this case, $28,000.

ii. Second, $28,000 must be multiplied by .0036—in this case resulting in 100.8.

iii. Third, 100.8 must be subtracted from 500. (The maximum allowable points and fees on any loan is five percent of the total loan amount for loans of less than $20,000. Five percent expressed in basis points is 500). Five hundred minus 100.8 equals 399.2, which is the allowable points and fees in basis points.

iv. Finally, the allowable points and fees in basis points must be translated into the appropriate percentage of the "total loan amount," which is achieved by multiplying 399.2 by .01. The result is 3.99 percent. Accordingly, the allowable points and fees for this $50,000 loan as a dollar figure is 3.99 percent of $48,000 or $1,915.20.

Paragraph 43(e)(3)(ii).

1. *Charges not retained by the creditor, loan originator, or an affiliate of either.* In general, a creditor is not required to count in "points and fees" for a qualified mortgage any bona fide third party charge not retained by the creditor, loan originator, or an affiliate of either. For example, if a creditor charges a consumer $400 for an appraisal conducted by a third party not affiliated with the creditor, pays the third party appraiser $300 for the appraisal, and retains $100, the creditor may exclude $300 of this fee but count the $100 it retains in "points and fees" for a qualified mortgage.

2. *Private mortgage insurance.* For qualified mortgages, the exclusion for

bona fide third party charges not retained by the creditor, loan originator, or an affiliate of either is limited by § 226.32(b)(1)(i)(B) in the general definition of "points and fees." Section 226.32(b)(1)(i)(B) requires inclusion in "points and fees" of premiums or other charges payable at or before closing for any private guaranty or insurance protecting the creditor against the consumer's default or other credit loss to the extent that the premium or charge exceeds the amount payable under policies in effect at the time of origination under section 203(c)(2)(A) of the National Housing Act (12 U.S.C. 1709(c)(2)(A)). These premiums or charges must also be included if the premiums or charges are not required to be refundable on a pro-rated basis, or the refund is not required to be automatically issued upon notification of the satisfaction of the underlying mortgage loan. Under these circumstances, even if the premiums or other charges are not retained by the creditor, loan originator, or an affiliate of either, they must be included in the "points and fees" calculation for qualified mortgages. *See* comments 32(b)(1)(i)–3 and –4 for further discussion of including upfront private mortgage insurance premiums in the points and fees calculation.

3. *Exclusion of up to two bona fide discount points.* Section 226.43(e)(3)(ii)(B) provides that, under certain circumstances, up to two "bona fide discount points," as defined in § 226.43(e)(3)(iii), may be excluded from the "points and fees" calculation for a qualified mortgage. The following example illustrates the rule:

i. Assume a covered transaction that is a first-lien, purchase money home mortgage with a fixed interest rate and a 30-year term. Assume also that the consumer locks in an interest rate of 6.00 percent on May 1, 2011, that was discounted from a rate of 6.50 percent because the consumer paid two discount points. Finally, assume that the average prime offer rate (APOR) as of May 1, 2011 for home mortgages with a fixed interest rate and a 30-year term is 5.50 percent.

ii. The creditor may exclude two discount points from the "points and fees" calculation because the rate from which the discounted rate was derived (6.50 percent) exceeded APOR for a comparable transaction as of the date the rate on the covered transaction was set (5.25 percent) by only one percent. For the meaning of "comparable transaction," refer to comment 43(e)(3)(ii)–5.

4. *Exclusion of up to one bona fide discount point.* Section 226.43(e)(3)(ii)(C) provides that, under certain circumstances, up to one "bona fide discount point," as defined in § 226.43(e)(3)(iii), may be excluded from the "points and fees" calculation for a qualified mortgage. The following example illustrates the rule:

i. Assume a covered transaction that is a first-lien, purchase money home mortgage with a fixed interest rate and a 30-year term. Assume also that the consumer locks in an interest rate of 6.00 percent on May 1, 2011, that was discounted from a rate of 7.00 percent because the consumer paid four discount points. Finally, assume that the average prime offer rate (APOR) as of May 1, 2011, for home mortgages with a fixed interest rate and a 30-year term is 5.00 percent.

ii. The creditor may exclude one discount point from the "points and fees" calculation because the rate from which the discounted rate was derived (7.00 percent) exceeded APOR for a comparable transaction as of the date the rate on the covered transaction was set (5.00 percent) by only two percent.

5. *Comparable transaction.* The table of average prime offer rates published by the Board indicates how to identify the comparable transaction. *See* comment 45(a)(2)(ii)-2.

43(f) Balloon-payment qualified mortgages made by certain creditors.

43(f)(1) Exception.

Paragraph 43(f)(1)(i).

1. *Satisfaction of qualified mortgage requirements.* Under § 226.43(f)(1)(i), a qualified mortgage that provides for a balloon payment must satisfy all of the requirements for a qualified mortgage in § 226.43(e)(2), other than § 226.43(e)(2)(i)(B), (e)(2)(i)(C), and (e)(2)(iv). Therefore, to satisfy this condition, a covered transaction with balloon payment terms must provide for regular periodic payments that do not result in an increase of the principal balance, pursuant to § 226.43(e)(2)(i)(A); must have a loan term that does not exceed 30 years, pursuant to § 226.43(e)(2)(ii); must have total points and fees that do not exceed specified thresholds pursuant to § 226.43(e)(2)(iii); and must satisfy the consideration and verification requirements in § 226.43(e)(2)(v).

Paragraph 43(f)(1)(ii).

1. *Example.* Under § 226.43(f)(1)(ii), if a qualified mortgage provides for a balloon payment, the creditor must determine that the consumer is able to make all scheduled payments under the legal obligation other than the balloon payment. For example, assume a loan in an amount of $200,000 that has a five-year loan term, but is amortized over 30 years. The loan agreement provides for a fixed interest rate of 6%. The loan consummates on March 15, 2011, and the monthly payment of principal and interest scheduled for the first five years is $1,199, with the first monthly payment due on May 1, 2011. The balloon payment of $187,308 is required on the due date of the 60th monthly payment, which is April 1, 2016. The loan remains a qualified mortgage if the creditor underwrites the loan using the scheduled principal and interest payment of $1,199 (plus all mortgage-related obligations, pursuant to § 226.43(f)(1)(iii)(B)).

2. *Creditor's determination.* A creditor must determine that the consumer is able to make all scheduled payments other than the balloon payment to satisfy § 226.43(f)(1)(ii), but the creditor is not required to meet the repayment ability requirements of § 226.43(c)(2)–(7) because those requirements apply only to covered transactions that are not qualified mortgages. Nevertheless, a creditor satisfies § 226.43(f)(1)(ii) if it complies with the requirements of § 226.43(c)(2)–(7). A creditor also may make the determination that the consumer is able to make the scheduled payments (other than the balloon payment) by other means. For example, a creditor need not determine that the consumer is able to make the scheduled payments based on a payment amount that is calculated in accordance with § 226.43(c)(5)(ii)(A) or may choose to consider a debt-to-income ratio that is not determined in accordance with § 226.43(c)(7).

Paragraph 43(f)(1)(iii).

1. *Amortization period.* Under § 226.43(f)(1)(ii), if a qualified mortgage provides for a balloon payment, the creditor must determine that the consumer is able to make all scheduled payments under the legal obligation other than the balloon payment. Under § 226.43(f)(1)(iii), those scheduled payments must be determined using an amortization period that does not exceed 30 years and must include all mortgage-related obligations. Balloon payments often result when the periodic payment would fully repay the loan amount only if made over some period that is longer than the loan term. For example, a loan term of 10 years with periodic payments based on an amortization period of 20 years would result in a balloon payment being due at the end of the loan term. Whatever the loan term, the amortization period used to determine the scheduled periodic payments that the consumer must pay under the terms of the legal obligation may not exceed 30 years.

Paragraph 43(f)(1)(v).

1. *Creditor qualifications.* Under § 226.43(f)(1)(v), to make a qualified mortgage that provides for a balloon payment, the creditor must satisfy the following four criteria:

i. During the preceding calendar year, the creditor extended over 50% of its total covered transactions with balloon payment terms in counties that are "rural" or "underserved," as defined in § 226.43(f)(2). Pursuant to that section, the Board determines annually which counties in the United States are rural or underserved and publishes on its public Web site a list of those counties to enable creditors to determine whether they meet this criterion. Thus, for example, if a creditor originated 90 covered transactions with balloon payment terms during 2010, the creditor meets this element of the exception in 2011 if at least 46 of those loans are secured by properties located in one or more counties that are on the Board's list for 2010.

Alternative 1—Paragraph 43(f)(1)(v)–1.ii

ii. During the preceding calendar year, the creditor together with all affiliates extended covered transactions with principal amounts that in the aggregate total $____ or less.

Alternative 2—Paragraph 43(f)(1)(v)–1.ii

ii. During the preceding calendar year, the creditor together with all affiliates extended ___ or fewer covered transactions.

Alternative 1—Paragraph 43(f)(1)(v)–1.iii

iii. On and after [effective date of final rule], the creditor has not sold, assigned, or otherwise transferred legal title to the debt obligation for any covered transaction with a balloon-payment term.

Alternative 2—Paragraph 43(f)(1)(v)–1.iii

iii. During the preceding or current calendar year, the creditor has not sold, assigned, or otherwise transferred legal title to the debt obligation for any covered transaction with a balloon-payment term. Thus, for example, if a creditor sells a covered transaction with a balloon-payment term on April 1, 2012, the creditor becomes ineligible for the exception for the remainder of 2012 (but not retroactively for January through March of 2012) and all of 2013. If the creditor sells no covered transactions with balloon-payment terms during 2013, it then may become eligible again for the exception beginning on January 1, 2014 and remains eligible until and unless it sells such loans during 2014.

iv. As of the end of the preceding calendar year, the creditor had total assets that do not exceed the current asset threshold established by the Board. For calendar year 2011, the asset threshold is $2,000,000,000. Creditors that had total assets of $2,000,000,000 or less on December 31, 2010 satisfy this criterion for purposes of the exception during 2011.

43(f)(2) "Rural" and "underserved" defined.

1. *Requirements for "rural or underserved" status.* A county is considered "rural or underserved" for purposes of § 226.43(f)(1)(v)(A) if it satisfies either of the two tests in § 226.43(f)(2). The Board applies both tests to each county in the United States and, if a county satisfies either test, includes that county on the annual list of "rural or underserved" counties. The Board publishes on its public Web site the applicable list for each calendar year by the end of that year. A creditor's originations of covered transactions with balloon-payment terms in such counties during that year are considered in determining whether the creditor satisfies the condition in § 226.43(f)(1)(v)(A) and therefore will be eligible for the exception during the following calendar year. The Board determines whether each county is "rural" by reference to the currently applicable Urban Influence Codes (UICs), established by the United States Department of Agriculture's Economic Research Service (USDA–ERS). Specifically, the Board classifies a county as "rural" if the USDA–ERS categorizes the county under UIC 7, 10, 11, or 12. The Board determines whether each county is "underserved" by reference to data submitted by mortgage lenders under the Home Mortgage Disclosure Act (HMDA).

43(g) Prepayment penalties.

43(g)(2) Limits on prepayment penalties.

1. *Maximum period and amount.* Section 226.43(g)(2) establishes the maximum period during which a prepayment penalty may be imposed and the maximum amount of the prepayment penalty. A covered transaction may include a prepayment penalty that may be imposed during a shorter period or in a lower amount than provided under § 226.43(g)(2). For example, a covered transaction may include a prepayment penalty that may be imposed for two years after consummation and equals two percent of the amount prepaid in each of those two years.

43(g)(3) Alternative offer required.

Paragraph 43(g)(3)(i).

1. *Same type of interest rate.* Under § 226.43(g)(3)(i), if a creditor offers a consumer a covered transaction with a prepayment penalty, the creditor must offer the consumer an alternative covered transaction without a prepayment penalty and with an annual percentage rate that cannot increase after consummation. Further, the covered transaction with a prepayment penalty and the alternative covered transaction without a prepayment penalty must both be fixed-rate mortgages or both be step-rate mortgages, as defined in § 226.18(s)(7)(iii) and (ii), respectively.

Paragraph 43(g)(3)(iv).

1. *Points and fees.* Whether or not an alternative covered transaction without a prepayment penalty satisfies the points and fees conditions for a qualified mortgage is determined based on the information known to the creditor at the time the creditor offers the consumer the transaction. At the time a creditor offers a consumer an alternative covered transaction without a prepayment penalty under § 226.43(g)(3), the creditor may know the amount of some, but not all, of the points and fees that will be charged for the transaction. For example, a creditor may not know that a consumer intends to buy single-premium credit unemployment insurance, which would be included in the points and fees for the covered transaction. The points and fees condition under § 226.43(g)(3)(ii)(C) is satisfied if a creditor reasonably believes, based on information known to the creditor at the time the offer is made, that the amount of points and fees to be charged for an alternative covered transaction without a prepayment penalty will be less than or equal to the amount of points and fees allowed for a qualified mortgage under § 226.43(e)(2)(iii).

Paragraph 43(g)(3)(v).

1. *Transactions for which the consumer likely qualifies.* Under § 226.43(g)(3)(v), the alternative covered transaction without a prepayment penalty the creditor must offer under § 226.43(g)(3) must be a transaction for which the creditor has a good faith belief the consumer likely qualifies. For example, assume the creditor has a good faith belief the consumer can afford monthly payments of up to $800. If the creditor offers the consumer a fixed-rate mortgage with a prepayment penalty for which monthly payments are $700 and an alternative covered transaction without a prepayment penalty for which monthly payments are $900, the requirements of § 226.43(g)(3)(v) are not met. The creditor's belief that the consumer likely qualifies for the

covered transaction without a prepayment penalty should be based on the information known to the creditor at the time the creditor offers the transaction. In making this determination, the creditor may rely on information provided by the consumer, even if the information subsequently is determined to be inaccurate.

43(g)(4) Offer through a mortgage broker.

1. *Rate sheet.* Under § 226.43(g)(4), where the creditor offers covered transactions with a prepayment penalty to consumers through a mortgage broker, as defined in § 226.36(a)(2), the creditor must present the mortgage broker an alternative covered transaction that satisfies the requirements of § 226.43(g)(3). Creditors may comply with this requirement by providing a rate sheet to the mortgage broker that states the terms of such an alternative covered transaction without a prepayment penalty.

2. *Alternative to creditor's offer.* Section 226.43(g)(4)(ii) requires that the creditor provide, by agreement, for the mortgage broker to present the consumer an alternative covered transaction without a prepayment penalty offered by either (1) the creditor, or (2) another creditor, if the other creditor offers a covered transaction with a lower interest rate or a lower total dollar amount of origination points or fees and discount points. The agreement may provide for the mortgage broker to present both the creditor's covered transaction and a covered transaction offered by another creditor with a lower interest rate or a lower total dollar amount of origination points or fees and discount points. See comment 36(e)(3)–3 for guidance in determining which step-rate mortgage has a lower interest rate.

3. *Agreement.* The creditor's agreement with a mortgage broker for purposes of § 226.43(g)(4) may be part of another agreement with the mortgage broker, for example, a compensation agreement. Thus, the creditor need not enter into a separate agreement with the mortgage broker with respect to each covered transaction with a prepayment penalty.

43(g)(5) Creditor that is a loan originator.

1. *Loan originator.* The definition of "loan originator" in § 226.36(a)(1) applies for purposes of § 226.43(g)(5). Thus, a loan originator includes any creditor that satisfies the definition of loan originator but makes use of "table-funding" by a third party. *See* comment 36(a)–1.i, –1.ii.

2. *Lower interest rate.* Under § 226.43(g)(5), a creditor that is a loan originator must present an alternative covered transaction without a prepayment penalty that satisfies the requirements of § 226.43(g)(3) offered by either the assignee for the covered transaction or another person, if that other person offers a transaction with a lower interest rate or a lower total dollar amount of origination points or fees or discount points. See comment 36(e)(3)–3 for guidance in determining which step-rate mortgage has a lower interest rate.

43(h) Evasion; open-end credit.

1. *Subject to closed-end credit rules.* Where a loan is documented as open-end credit but the features and terms or other circumstances demonstrate that it does not meet the definition of open-end credit, the loan is subject to the rules for closed-end credit, including § 226.43.◄

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By order of the Board of Governors of the Federal Reserve System, April 18, 2011.

Jennifer J. Johnson,

Secretary of the Board.

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