

# RESCINDED

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Department of the Treasury

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*Transmittal*

## TR-483

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On May 11, 2011 the Federal Reserve Board issued a proposed rule under Regulation Z that requires creditors to determine a consumer's ability to repay a mortgage before making the loan and establishes minimum mortgage underwriting standards.



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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](mailto: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.<sup>1</sup> 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(j)(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(j)(2)(A). TILA Section 129(j)(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(j)(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(j)(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

<sup>1</sup> 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").<sup>2</sup> 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(j)(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

<sup>2</sup> The 2006 Nontraditional Mortgage Guidance and the 2007 Subprime Mortgage Statement will hereinafter collectively be referred to as the "Interagency Supervisory Guidance."

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.<sup>3</sup> Sections 1411,

<sup>3</sup> 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”).<sup>4</sup> 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

<sup>4</sup> 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”<sup>5</sup> or not.

<sup>5</sup> The Act provides separate underwriting requirements for balloon loans depending on whether the loan’s APR exceeds the APOR by 1.5

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

percent for a first-lien loan or by 3.5 percent for a subordinate-lien loan.

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



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.<sup>6</sup> 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.<sup>7</sup> 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.<sup>8</sup> 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

<sup>6</sup>Public Law 111-203, 124 Stat. 1376, Title XIV, § 1431.

<sup>7</sup>*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).

<sup>8</sup>*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.”<sup>9</sup> 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.<sup>10</sup>

### 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).<sup>11</sup> 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.<sup>12</sup> 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

<sup>9</sup> 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).

<sup>10</sup> 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.

<sup>11</sup> 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.

<sup>12</sup> 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.<sup>13</sup> 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 guaranty 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.

<sup>13</sup> 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),<sup>14</sup> not the term "mortgage

originator" under Section 1401 of the Dodd-Frank Act.<sup>15</sup> 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

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).

<sup>15</sup> Public Law 111–203, 124 Stat. 1376, Title XIV, § 1401.

<sup>14</sup> 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



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<sup>16</sup> 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

<sup>16</sup> 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.<sup>17</sup> 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

<sup>17</sup> 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.*

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.<sup>18</sup>

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-

<sup>18</sup> 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.<sup>19</sup>

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 renumbered 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

<sup>19</sup> 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.<sup>20</sup>

*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.<sup>21</sup>

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*

<sup>20</sup> 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 \* \* \* 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).

<sup>21</sup> 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).

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

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.”<sup>22</sup> 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

<sup>22</sup> *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.<sup>23</sup> 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,<sup>24</sup> 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

<sup>23</sup> 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.

<sup>24</sup> 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.<sup>25</sup> 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

<sup>25</sup> 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)(i)(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,<sup>26</sup> 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.<sup>27</sup> 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

<sup>26</sup> 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).

<sup>27</sup> 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.<sup>28</sup>

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.<sup>29</sup> 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.

<sup>28</sup> 2011 Escrow Proposal, 76 FR 11598, 11626–11627, Mar. 2, 2011.

<sup>29</sup> *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 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,<sup>30</sup> which addresses disclosure requirements for negative amortization loans, and the 2006 Nontraditional Mortgage Guidance, which provides guidance to creditors regarding underwriting negative amortization loans.<sup>31</sup>

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

<sup>30</sup> 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.

<sup>31</sup> 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).<sup>32</sup> 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.<sup>33</sup> *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

<sup>32</sup> 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).

<sup>33</sup> 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),<sup>34</sup> 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),<sup>35</sup> 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),<sup>36</sup> 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.”<sup>37</sup>

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

<sup>34</sup> “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).

<sup>35</sup> “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).

<sup>36</sup> “[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).

<sup>37</sup> *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.<sup>38</sup>

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.<sup>39</sup> 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,<sup>40</sup> 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.*,

<sup>38</sup> See 2006 Nontraditional Mortgage Guidance, 71 FR 58609, 58614 (Oct. 4, 2006).

<sup>39</sup> 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.

<sup>40</sup> 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](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."<sup>41</sup> 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

<sup>41</sup> 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);<sup>42</sup> 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

<sup>42</sup> 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 rapid 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)(J), 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).<sup>43</sup>

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

<sup>43</sup> 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.<sup>44</sup> 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

<sup>44</sup> *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,<sup>45</sup> 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.<sup>46</sup> 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

<sup>45</sup> See 12 CFR 226.18(s)(2)(ii) and comment 18(s)(2)(ii)–2.

<sup>46</sup> 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