CFPB Issues Final and Proposed Rules Amending Regulation Z, As Required by Dodd-Frank

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On Thursday, January 10, the Consumer Financial Protection Bureau (the ?Bureau?) issued a final rule amending its Regulation Z (Truth in Lending) in order to implement certain changes required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the ?Act?). At the same time, the Bureau issued proposed rules relating to the final rule.

On May 11, 2011, the Federal Reserve Board, at the time authorized to implement amendments to Regulation Z, issued proposed rules with respect to changes to the Truth in Lending Act mandated by the Act. Specifically, the proposed rules addressed changes to the ?ability-to-pay? rule and certain related provisions. Authority to implement changes to Regulation Z has since passed to the Bureau. The proposed rules were reported in this publication on May 27, 2011.

The Bureau?s final rule amends Regulation Z in the following four main areas:

1. *Expansion of the ?Ability-to-Pay? Rule*. Currently, Regulation Z requires certain underwriting standards for ?high-cost mortgages,? as required by the Home Ownership and Equity Protection Act (HOEPA). Among these requirements is a determination by the lender of the borrower?s ability to repay the loan. The Bureau?s rule applies a similar, though not identical, ability-to-pay standard to any consumer credit transaction secured by a dwelling, except for open-end credit plans, timeshares, reverse mortgages and temporary loans (those with a term of 12 months or less). The final rule

prohibits a lender from making such a loan unless it makes a reasonable and good faith determination, based upon appropriate documentation, that the borrower will have a reasonable ability to repay the loan (including related costs, such as escrowed payments).

2. *Standards for Compliance with the ?Ability-to-Pay? Rule*. The final rule provides several options for lenders to comply with the new ability-to-pay rule:

(a) By originating a mortgage loan for which (i) the lender considers, and verifies, all of the 8 factors discussed in the proposed rules and (ii) the mortgage payment calculation is based upon the fully indexed rate (or the initial rate, if higher) and other assumptions, depending upon the terms of the loan.

(b) By refinancing a ?non-standard mortgage? into a ?standard mortgage.? A ?standard mortgage? would be defined as one that, among other things, does not have negative amortization, interest-only payments, or balloon payments, has a fixed rate for at least 5 years, and has limited points and fees.

(c) By originating a ?qualified mortgage.? The final rule provides a conclusive presumption (i.e., a ?safe harbor?) that the borrower is able to repay the loan if the loan is a ?qualified mortgage? and is not a ?higher-priced? loan (generally the same as a ?high-cost mortgage? under HOEPA). The final rule also provides a strong (but rebuttable) presumption that the borrower is able to repay the loan if the loan is a ?qualified mortgage? and is a ?higher-priced? loan.

(d) While the general requirements for a ?qualified mortgage? set forth in the 2011 proposed rules were generally adopted, the final rule also provides for a separate, temporary category of ?qualified mortgage.? This category is temporary because it is intended to address loans that are responsibly underwritten but do not technically qualify as ?qualified mortgages? under the regulation. The Bureau is concerned that the strict definitions in the Act will have a chilling effect on mortgage lending in a fragile mortgage market. As the mortgage market strengthens, the need for the special category will disappear. With these loans, the underwriting requirements are more flexible, but the loan must satisfy the general product feature prerequisites for a ?qualified mortgage? and satisfy the underwriting requirements of the GSEs (such as Fannie Mae) while they are under federal conservatorship, or those of other listed federal government agencies. This temporary category will sunset in 7 years.

(e) In certain circumstances, by originating a balloon-payment qualified mortgage that meets the criteria set forth in the Act. This option is available only to small lenders (less than $2 billion in assets) operating in rural or underserved areas. Less than 50% of the lender?s first-lien mortgage portfolio can be comprised of these loans, and no more than 500 such loans may be made by the lender and its affiliates combined. Such loans would need to remain in the lender?s portfolio for at least 3 years to remain ?qualified.? The lender may originate a balloon-payment ?qualified mortgage? if the loan term is five years or more and the payment calculation is based upon the scheduled periodic payments, excluding the balloon payment. These loans would be subject to the same points and fees requirements, and generally the same underwriting requirements, as other ?qualified mortgages.?

3. *Limits on Prepayment Penalties*. A mortgage loan covered by the new rule may not contain a prepayment penalty unless the loan is a fixed-rate ?qualified mortgage? and the penalty satisfies certain restrictions set forth in the final rule. If a lender imposes a prepayment penalty on a loan offered to a borrower, it must also offer a loan to the borrower that does not contain a prepayment penalty.

4. *Record Retention*. Lenders are required to maintain evidence of compliance with these requirements, as well as the rest of Regulation Z, for three years after consummation of the loan. The statute of limitations for civil liability for violations of the prepayment penalty and the ability-to-pay requirements (including the qualified mortgage provisions) is extended to three years after violation.

The final rule goes into effect on January 10, 2014.

The Bureau?s proposed rules, issued concurrently with the final rule, request comment on the following:

- Whether the final rule should be modified to exempt loans made pursuant to a program administered by the Housing Finance Agency and by certain non-profit lenders.
- Whether the final rule should be modified to exempt loans made pursuant to a program established under the Emergency Economic Stabilization Act, and certain similar programs administered by the FHA, VA or Department of Agriculture.
- Whether the final rule should be modified to exempt loans that are eligible for purchase or guarantee by FNMA or FHLMC, subject to certain restrictions set forth in the final rule.
- Whether to add an additional category of ?qualified mortgage? for loans that are originated or held by ?small creditors? (those having $2 billion or less in assets). These loans would be similar to the

category of rural balloon-payment loans described in Paragraph 2(e), above, except that balloon-payments would be prohibited, and the category would not be limited to lenders that operate primarily in rural or underserved areas.

- Whether to permit an increase in the threshold separating ?safe harbor? and ?rebuttable presumption? qualified mortgages for both rural balloon-payment mortgages and the new category of small-portfolio qualified mortgages, and the amount of the increase.

Lenders may comment, and should do so if they think that these changes, or the specifics of the implementation of these changes as published in the notice, will have an adverse effect on their businesses. According to the notice of proposed rulemaking, comment letters should refer to Docket No. CFPB-2013-0002 or RIN 3170-AA34 and may be mailed electronically to http://www.regulations.gov. The comment period ends February 25, 2013.

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