CLIENT AND FRIENDS BANKING UPDATE

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A DETAILED SUMMARY OF THE CFPB'S FINAL ABILITY TO REPAY RULES

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Summary The Consumer Finance Protection Board (CFPB) issued a final rule on January 10, 2013 (the "ATR rule") which amended Regulation Z under the Truth in Lending Act (TILA) in accordance with the Dodd-Frank Wall Street Reform and Borrower Protection Act (Act) and created new TILA Section 129C. TILA Section 129C established new ability-to-repay requirements in making a mortgage loan, prohibiting a lender from making a residential mortgage loan unless the lender makes a reasonable and good faith determination, based on verified and documented information, that the borrower has a reasonable ability to repay the loan according to its terms. It also created new limits on prepayment penalties and a presumption of compliance with the ability-to-repay requirements for certain "qualified mortgages." Qualified mortgages exclude negative amortization, balloon and interest-only loans, loan terms in excess of 30 years, "no-doc" loans for which verification of income was not required and generally loans when the total points and fees to the originator, lender, or affiliates exceed 3%. The statute of limitations 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 most other TILA violations). In addition, non-compliance with TILA Section 129C may be claimed at any time by a borrower in a foreclosure action "as a matter of defense by recoupment or setoff." This defense to foreclosure applies against assignees of the loan in addition to the original lender.

The CFPB adopted amendments to the ATR rule (the "Amendments") on May 29, 2013. In the Amendments the CFPB adopted exemptions from the ATR rule for homeownership stabilization and foreclosure prevention programs and for certain not for profit entities. In addition, it expanded the definition of a qualified mortgage to cover certain loans made and held in portfolio by small lenders and amended the method of calculating points and fees for purposes of determining loan originator compensation in order to avoid double counting. Both rules take effect on January 10, 2014.

- **Section 1026.43—Ability to Repay Rule ("ATR").** Under the ATR rule, a lender may not originate a residential mortgage loan without a reasonable and good faith determination that, at the time of the loan closing, the borrower has a reasonable ability to repay the loan, along with taxes, insurance, and assessments. These requirements apply to any "covered transaction." In general, this includes any closed-end, dwelling-secured credit transaction (regardless of whether the dwelling is a principal residence, second home, or vacation home). Therefore, except for home equity lines of credit (HELOCs), mortgage transactions secured by an interest in a timeshare plan, reverse mortgages, and the construction phase of a construction-to-permanent loan or a temporary loan with a term of 12 months or less are not covered transactions.

Dwelling means a residential structure that contains one to four units (including an individual condominium unit, cooperative unit, mobile home, and residential trailer), and any attached real property and that also secures the loan. The ATR rule does not apply to: (i) a loan primarily for a business, commercial or agricultural purpose, even if it is secured by a dwelling; (ii) any change to an existing loan that is not treated as a refinancing; or (iii) renewals of the construction phase or a temporary loan so long as the renewal term is one year or less. The permanent phase of a construction-to-permanent loan is considered a separate transaction that must comply with the ATR rule and may qualify as a qualified mortgage if it meets the qualified mortgage requirements, as discussed below.

In the Amendments, the CFPB amended the ATR rule to provide an exemption for homeownership stabilization and foreclosure prevention programs and certain not-for-profit entities. The Amendments exempted:

- Creditors designated by the U.S. Department of the Treasury as Community Development Financial Institutions;
- Creditors designated by the U.S. Department of Housing and Urban Development as either a Community Housing Development Organization or a Downpayment Assistance Provider of Secondary Financing;
- In general, creditors designated as nonprofit organizations under Section 501(c)(3) of the Internal Revenue Code that extend credit secured by a dwelling no more than 200 times annually, provide credit only to low-to moderate income consumers, and follow their own written procedures to determine that consumers have a reasonable ability to repay their loans;
- Loans made pursuant to programs administered by a Housing Finance Agency; and
- Loans made pursuant to an Emergency Economic Stabilization Act program, such as loans made pursuant to the Home Affordable Modification Program or a State Hardest Hit Fund program.

Section 1026.43(c) Repayment Ability Requirements

Underwriting Standards. In order to determine if a borrower has the ability to repay the loan, the CFPB did not require lenders to follow any particular underwriting standards. Lenders are permitted to develop and apply their own underwriting standards, and whether a particular ability-to-repay determination is reasonable and in good faith depends on the underwriting standards adopted, the borrower's individual facts and circumstances and how the adopted underwriting standards are applied. The following may indicate that a lender's ability-to-repay determination was reasonable and in good faith: (1) the borrower demonstrated actual ability to repay the loan by making timely payments, without modification or accommodation, for a significant period of time after closing or, for an adjustable-rate, interest-only, or negative-amortization mortgage, for a significant period of time after recast (the ATR rule uses the term "recast" to cover the conversion to generally less favorable terms and higher payments for interest only, negative amortization loans, and adjustable-rate mortgages); (2) the lender used underwriting standards that have historically resulted in comparatively low rates of delinquency and default during adverse economic conditions; or (3) the lender used underwriting standards based on empirically derived, demonstrably and statistically sound models. In contrast, the following may indicate that a lender's ability-to-repay determination was not reasonable or in good faith: (1) the borrower defaulted on the loan a short time after closing or, for an adjustable-

rate, interest-only, or negative-amortization mortgage, a short time after recast; (2) the lender used underwriting standards that have historically resulted in comparatively high levels of delinquency and default during adverse economic conditions; (3) the lender applied underwriting standards inconsistently or used underwriting standards different from those used for similar loans without reasonable justification; (4) the lender disregarded evidence that the underwriting standards it used are not effective at determining borrowers' repayment ability; (5) the lender consciously disregarded evidence that the borrower may have insufficient residual income to cover other recurring obligations and expenses, taking into account the borrower's assets other than the property securing the mortgage, after paying the monthly payments for the covered transaction, any simultaneous loan, mortgage-related obligations and any current debt obligations; or (6) the lender disregarded evidence that the borrower would have the ability to repay only if the borrower subsequently refinanced the loan or sold the property securing the loan.

Although no particular underwriting guidelines are required, Section 1026.43(c) does require lenders to consider eight underwriting factors: (1) current or reasonably expected income or assets (other than the value of the dwelling securing the loan); (2) current employment status (if the lender relies on employment income); (3) the monthly loan payment; (4) the monthly payment on any known simultaneous loan; (5) the monthly payment for mortgage-related obligations; (6) current debt obligations, alimony, and child support; (7) the monthly debt-to-income ratio or residual income; and (8) credit history. Lenders must generally use reasonably reliable third- party records to verify the information they use to evaluate these factors except that employment status may be orally confirmed provided the lender creates a written record of the verification. A "third-party record" means: (1) a document or other record prepared or reviewed by an appropriate person other than the borrower, the lender, any mortgage broker or an agent of the lender 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 lender maintains for an account of the borrower held by the lender; or (4) if the borrower is an employee of the lender or the mortgage broker, a document or other record regarding the borrower's employment status or income.

Income and assets. If not relied upon, such as an annual bonus, the lender need verify only the salary or other income relied upon. A lender may use a wide variety of documents to provide reasonably reliable evidence of the borrower's income or assets, such as: (1) copies of IRS or state tax returns or an IRS tax-return transcript or Form W-2; (2) payroll statements, including military Leave and Earnings Statements; (4) financial institution records; (5) records from the borrower's employer or a third party that contains income information from the borrower's employer; (6) a written or electronic record from a government agency of the borrower's benefit payments or entitlement, such as a "proof of income" letter issued by the Social Security Administration; and (7) check cashing or funds transfer services receipts. In addition, a document or other record prepared by the borrower, the lender, the mortgage broker, or an agent of the lender or mortgage broker, and reviewed by a third party, such as an income statement prepared by a self-employed borrower and reviewed by a third-party accountant is also a third-party record. Although records not reviewed by a third party are insufficient, the CFPB noted that they may nevertheless be useful. For example, the lender may consider and verify a self-employed borrower's income from the borrower's 2013 income tax return or audited income statement, and the borrower then may offer an unaudited year-to-date income statement that reflects significantly lower expected income in 2014. The lender might reasonably use the lower 2014 income figure as a more conservative method of underwriting. However, if the unverified 2014 income reflects significantly greater income than the income tax return showed for 2013, a lender instead should verify this information with additional records.

Monthly Loan Payment Calculation. Monthly payments must generally be calculated by assuming that the loan is repaid in substantially equal monthly payments during its term. For adjustable-rate mortgages, the monthly payment must be calculated using the fully indexed rate or an introductory rate, whichever is higher. Special payment calculation rules apply for loans with balloon payments, interest-only payments, or negative amortization.

For all loans other than balloon payment loans, when calculating the monthly payment, the lender must use a fully amortizing payment schedule and assume that: (1) the loan proceeds are fully disbursed on the loan closing date; (2) the loan is repaid in substantially equal, monthly amortizing payments of principal and interest that will fully repay the loan over the remaining loan term (in the case of interest only and negative amortization loans, the remaining loan term is determined from the date the interest only or negative amortization period ends, respectively); 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, using the higher of the introductory or fully-indexed rate. In practice, for a fixed rate or adjustable rate loan, the substantially equal monthly amortizing payment is equal to the first scheduled monthly payment that includes repayment of principal and payment of interest at the fixed or fully indexed rate. For fixed and step-rate loans, the note's maximum interest rate is the fully indexed rate. For an adjustable rate loan, the fully indexed rate is calculated using the applicable index at the time of closing plus the margin without giving effect to any interest rate adjustment caps (if this calculation exceeds the note's maximum interest rate, the maximum interest rate can be used as the fully-indexed rate). For example, assume a five year, interest only ARM loan with an initial rate of 5% for the first three years, adjusting each year based on a specified index plus a margin of 3%, subject to an annual interest rate adjustment cap of 2% in an amount of $200,000 and a 30-year loan term. The index value in effect at closing is 4.5% so the fully indexed rate is 7.5% (4.5% plus 3%). The monthly payments for the first three years are $833. For the fourth year, the payments are $1,167, based on an interest rate of 7%, calculated by adding the 2% annual adjustment cap to the initial 5% rate. For the fifth year, the payments are $1,250, applying the fully indexed rate of 7.5%. When the loan is recast on the due date of the 60th monthly payment, the scheduled monthly payments will be $1,478, a monthly payment that will repay the loan amount of $200,000 over the remaining 25 years of the loan (300 months) at the fully indexed rate of 7.5%. For purposes of the ATR rule, the borrower's monthly loan payment is $1,478, which reflects repayment of the $200,000 principal balance over the 25 years remaining years using the fully indexed rate of 7.5%.

For loans with a balloon payment, the maximum payment during the first five years after the date of the first regularly scheduled payment is used as the monthly payment so long as the loan is not a "higher-priced covered transaction" and the balloon payment does not occur within the five year period. In a higher priced covered transaction the annual interest rate exceeds the average prime offer rate for a comparable transaction as of the date the interest rate is set as published by the CFPB (the APOR) by at least 1.5% for a first-lien covered transaction or by at least 3.5% for a subordinate-lien covered transaction, the same thresholds as under the Home Ownership and Equity Protection Act (HOEPA) other than certain qualified mortgages originated by a lender that originated 500 or fewer covered transactions, secured by a first lien, in the preceding calendar year, with assets equal to or under $2 billion (to be adjusted annually by the CFPB) (lenders meeting this definition are referred to as a "Small Lender"). For a Small Lender, a first-lien covered transaction is considered a higher priced covered transaction if the interest rate exceeds the APOR by 3.5% or more percentage points. For these higher priced loans, the lender must consider the borrower's ability to repay the loan based on the maximum payment in the payment

schedule, including the balloon payment. For negative amortization loans, the monthly payment is calculated using the fully indexed rate multiplied by the maximum loan amount divided by the remaining loan term. The maximum loan amount is calculated by adding accrued but unpaid interest to the principal balance and assuming: (i) the borrower makes the minimum monthly payments until any negative amortization cap is reached or until the period permitting minimum periodic payments expires, whichever occurs first; and (ii) that the interest rate rises as quickly as possible after closing, taking into account any periodic interest rate adjustment caps. For an adjustable-rate negative amortization mortgage with a lifetime maximum interest rate but no periodic interest rate adjustment cap, the lender must assume that the interest rate increases to the maximum lifetime interest rate at the first adjustment. Additional examples of the monthly payment calculation for different loan types are provided in the comments to the ATR rule.

Monthly payment on any known simultaneous loans. A simultaneous loan is defined as another covered transaction or HELOC, whether it is made by the same lender or a third-party lender that will be secured by the same dwelling and made to the same borrower at or before the loan closing or, if made afterwards, to cover closing costs of the first transaction. A HELOC that is a simultaneous loan that the lender knows or has reason to know about must be considered as a mortgage obligation in determining a borrower's ability to repay the covered transaction even though the HELOC itself is not a covered transaction subject to the ATR rule. The monthly payment for a simultaneous loan is calculated in the same manner set forth above except that a lender must calculate the monthly payment required pursuant to the terms of the HELOC by considering only the actual amount of credit to be drawn by the borrower at the loan closing. The lender may comply with the knowledge requirement by following reasonable underwriting policies and procedures that are designed to determine whether at or before closing the same borrower has applied for another credit transaction secured by the same dwelling. For example, if the loan amount is less than the home purchase price, the lender's policies and procedures must require the borrower to state the source of the down payment and provide verification. If the source of the down payment is another borrowing secured by the same dwelling that will be made to the same borrower at or before closing, the monthly payments for this simultaneous loan should be included in the lender's calculation of the borrower's monthly payment. The simultaneous loan should be verified by obtaining a copy of the promissory note or other written verification from the third-party lender. Alternatively, if the lender has information that existing assets are the source of the down payment no further action is required. For purposes of the ATR rule, when there are two or more borrowers on a loan and only one borrower is obligated on the other simultaneous loan, the monthly payment for the simultaneous loan is considered in the ability to repay determination only for that borrower and is excluded from the determination for the other borrower.

Monthly Payment for Mortgage-Related Obligations. Under the ATR rule "mortgage-related obligations" include property taxes and other obligations that are equivalent to property taxes (for example, assessments or surcharges on properties to fund a special purpose, such as a local development bond district, water district, or other public purpose) whether paid on a monthly, quarterly, annual, or other basis. Also included are premiums and similar charges that the borrower is required to pay or reimburse the lender for, including: (i) any guarantee or insurance protecting the lender against the borrower's default or other credit loss, whether called mortgage insurance, guarantee insurance or otherwise; and (ii) if written in connection with the loan, premiums for (a) credit life, accident, health, or loss-of-income insurance; (b) insurance for property loss or damage or against liability arising out of the ownership or use of property; and (c) debt cancellation or debt suspension coverage, whether or not the premium or similar charge is excluded from the finance charge pursuant to Section 1026.4(d). For example, if Federal law requires flood insurance to be

obtained in connection with the mortgage loan, the flood insurance premium is a mortgage-related obligation. In contrast, if earthquake insurance is not required by the lender to be obtained in connection with the mortgage loan, yet the borrower purchases such insurance, the earthquake insurance premium is not a mortgage-related obligation. Further, if a borrower purchases homeowners' insurance in excess of the minimum amount required, only the portion of the premium allocated to the required minimum coverage is a mortgage-related obligation. Fees and special assessments imposed by a condominium, cooperative, or homeowners association, ground rent, and leasehold payments are also mortgage-related obligations.

Current Debt Obligations and Credit History. The ATR rule requires an evaluation of current debt obligations, as well as alimony and child support (whether or not they are paid in a timely manner) and the borrower's credit history. Examples of current debt obligations include student loans, automobile loans, revolving debt and existing mortgages that will not be paid off at or before closing. When verifying current debt obligations, a lender may look to credit reports, student loan statements, automobile loan statements, credit card statements, alimony or child support court orders and existing mortgage statements. If an obligation is likely to be paid off soon after closing, the lender may take that fact into account, such as an existing mortgage with a pending contract for sale of the underlying property. Any debt obligations in forbearance or deferral at the time of underwriting should also be considered in determining the borrower's ability to repay (i.e., how will they affect the borrower's ability to pay once the forbearance or deferral period has expired). When there is more than one borrower, the debt obligations and credit history of all borrowers must be evaluated. The debt obligations and credit history of a surety or guarantor of the loan, however, is not required to be evaluated.

An evaluation of credit history may include factors such as the number and age of credit lines, payment history and any judgments, collections or bankruptcies. The ATR rule does not require lenders to obtain or consider a consolidated credit score, apply a minimum credit score, or state which aspects of credit history a lender must consider or how various aspects of credit history should be weighed against each other or against other underwriting factors. A lender has the discretion to give as much or as little weight to each aspect of the borrower's credit history as appropriate to reach a reasonable, good faith determination of the ability to repay.

A credit report is generally a reasonable third party record unless the borrower knows or has reason to know the credit report is inaccurate in whole or in part; in which case the lender should disregard the inaccurate or disputed items and may, but is not required, to obtain other reasonably reliable third-party records to verify information with respect to which the credit report may be inaccurate. For example, when the borrower's application states a current debt obligation not shown in the borrower's credit report, the lender need not independently verify the additional debt obligation. For information typically not shown on a credit report, such as if an amount is in dispute, alimony or child support, whether a simultaneous loan is extended at or before closing, and certain mortgage related obligations, the lender may instead verify that information from a third-party or use a bill or statement from a taxing authority or local government or homeowners association, a valid and legally executed contract, such as a ground rent agreement, or a promissory note in the case of a simultaneous loan. A HUD-1 typically may not be used for verification purposes as the CFPB does not believe that a document provided in final form at closing, such as the HUD-1, should be used because the ability to repay determination is expected to be conducted in advance of closing.

Monthly debt-to-income ratio. For purposes of the monthly debt-to-income ratio, monthly debt is the aggregate of the monthly payments on the covered transaction, any known simultaneous loan, mortgage-related obligations and current debt obligations, alimony, and child support, as determined as set forth above. The term "total monthly income" means the sum of the borrower's current or reasonably expected income, including any income from assets. The CFPB believes that compensating factors should be used by lenders in determining an ability to repay because otherwise there may be reduced access to credit in some cases, even if the borrower could afford the mortgage. There is no specific debt-to-income ratio with which lenders must comply, rather the appropriate ratio is up to the lender to determine for each individual borrower (as compared to the definition of qualified mortgage, discussed below, which mandates a debt to income ratio of no more than 43%). For example, the lender may reasonably and in good faith determine that an individual borrower has the ability to repay, despite a high monthly debt-to-income ratio, because of the amount of the borrower's assets (other than the dwelling securing the loan), such as savings or the amount of residual income. Consistent with this position, the ATR rule does not provide a safe harbor for lenders relying on automated underwriting systems that use monthly debt-to-income ratios.

Section 1026.43(d) - Exemption from Repayment Ability Requirements for Refinancing Non-Standard Mortgages. The ATR rule includes special refinancing conditions designed to encourage borrowers and lenders to refinance an existing "non-standard mortgage," into a "standard mortgage," when the borrower is currently able to make mortgage payments yet is likely to be unable to make the payments after a recast, where payments suddenly become significantly higher – often referred to as "payment shock." The purpose behind this exception is to enable lenders, without going through full underwriting, to offer borrowers who are facing increased monthly payments due to the recast of a loan a new loan with lower monthly payments. By meeting the refinancing conditions, the lender is exempt from the general repayment ability requirements, discussed above, and may instead comply with special requirements, discussed below.

The availability of this exception is subject to several conditions that are intended to benefit the borrower. The refinancing must be of a non-standard mortgage into a standard mortgage. The term "refinancing" is generally defined in Section 1026.20(a) of Regulation Z as a transaction in which an existing obligation is satisfied and replaced by a new obligation undertaken by the same borrower, based on the parties' contract and applicable law. The CFPB specifically noted a renewal of a payment obligation with no change in the original terms, or a reduction in the annual percentage rate with a corresponding change in the payment schedule, are not considered refinancings and therefore are not subject to the special exception requirements.

A non-standard mortgage is defined as an adjustable-rate mortgage, with an introductory fixed interest rate for a period of one year or longer or a negative amortization or interest-only loan. The definition does not include balloon-payment mortgages, described below, because monthly payments on a balloon-payment mortgage do not necessarily increase or change from the time of closing, rather, the entire outstanding principal balance becomes due on a particular, predetermined date, and the refinancing exception was designed to address payment shock and not this type of risk. Accordingly, all balloon-payment loans must be underwritten in accordance with the general ability-to-repay requirements. In order to rely on this refinancing exception, non-standard mortgages closed on or after January 10, 2014 must have been made in accordance with the general ability-to-repay requirements. Otherwise, the CFPB believes a lender might attempt to use a refinancing to circumvent or "cure" non-compliance with the general ability to

repay requirements, such as substandard underwriting of the prior non-standard mortgage, and argue that the borrower may no longer raise as a defense to foreclosure the underwriting of the original nonstandard mortgage.

To qualify as a standard mortgage, the interest rate must be fixed for at least the first five years after closing and loan terms must provide for regular periodic payments (payments of principal and interest on a monthly or other periodic basis that will repay the loan amount over the loan term) that do not result in negative amortization, deferral of principal repayment, or a balloon payment. For payments resulting from any interest rate changes after closing in an adjustable-rate or step-rate mortgage, the periodic payments must be substantially equal. The loan term may be up to 40 years to allow for refinancing an unaffordable 30-year loan into a loan with lower, more affordable payments over a longer term. Loan proceeds may only be used to pay off the outstanding principal balance on the non-standard mortgage, and to pay closing or settlement charges required to be disclosed under the Real Estate Settlement Procedures Act (RESPA) (including amounts required to be deposited in an escrow account at or before closing). If the proceeds are used for other purposes, such as to pay off other liens or to provide additional cash to the borrower for discretionary spending, the transaction does not meet the definition of a "standard mortgage." In addition, the points and fees that the lender may charge may not exceed three percent of the total loan amount, with exceptions for smaller loans, calculated in accordance with Section 1026.32, as described below. This limitation is intended to prevent lenders from charging excessive points and fees for the refinance to ensure that borrowers attain a net benefit in refinancing their nonstandard mortgage and increase the likelihood that the borrower will hold the loan long enough to recoup those costs.

In order to refinance a non-standard mortgage into a standard mortgage and qualify for the exception from the general ability to repay requirements, the following conditions must also be met:

- The lender of the standard mortgage is the current holder of the existing non-standard mortgage or the servicer acting on behalf of the current holder. The CFPB considers the existing relationship important because the current lender can easily access the borrower's payment history and other potentially relevant information about the borrower in lieu of requiring new documentation of the borrower's income and assets. It also ensures that the lender of the refinancing has an interest in placing the borrower into a new loan that is affordable and beneficial. By permitting the lender on the refinanced loan to be the servicer acting on behalf of the holder of the existing mortgage, the refinancing exception applies to a loan that has been sold to a GSE, refinanced by the existing servicer, and continues to be held by the same GSE.

- The monthly payment for the standard mortgage is materially reduced from the monthly payment for the non-standard mortgage. The CFPB adopted a 10% safe harbor for what constitutes a "material" reduction. The monthly payment calculation for a refinancing under the ATR rule differs from the general ability to repay rules in Section 1026.43(c) as the refinancing is not subject to those rules.

To determine whether the monthly periodic payment for a standard mortgage is materially lower than the monthly periodic payment for the non-standard mortgage, the monthly payment for a standard mortgage must be calculated based on substantially equal, monthly, fully amortizing payments using the maximum interest rate that may apply to the standard mortgage within the first five years after closing. For a mortgage with a single, fixed rate for the first five years, the

maximum rate that will apply during the first five years after closing will be the rate at closing. For a step-rate mortgage, the rate that must be used is the highest rate that will apply during the first five years after closing.

The lender calculates the monthly payment for the non-standard mortgage based on substantially equal payments of principal and interest that amortize the remaining loan amount over the remaining term as of the date the mortgage is recast (assuming all schedule payments have been made through and including the recast date, except that for a negative amortization loan, the remaining loan amount is equal to the maximum loan amount, adjusted for the outstanding principal balance) and using the fully indexed rate (calculated in the same manner as the monthly payment calculation under the general ability to repay rules) as of a reasonable period of time before or after the date on which the lender receives the borrower's written application for the standard mortgage. Thirty days is generally considered to be a reasonable period of time.

The calculation of the monthly payment for a nonstandard mortgage is based on substantially equal, monthly, fully amortizing payments of principal and interest because the existing payment, such as for an interest-only or negatively amortizing loan, may be artificially low compared to the standard mortgage payment. If so, it could be difficult for lenders to materially reduce the payment with a refinanced loan that has a comparable term length and principal amount. For example, assume a loan originated on February 15, 2014 in an amount of $200,000 with a 30-year loan term, at an interest rate of five percent that is fixed for the first two years, adjusting annually afterward based on an index plus a margin of three percent. The lender receives the application to refinance on March 15, 2015 when the index is at 4.5%. The first monthly payment due was April 1, 2014, so the recast date (the due date of the 24th monthly payment), is March 1, 2016. Based on the above assumptions, the nonstandard mortgage payment for comparison purposes is $1,383 representing the substantially equal, monthly payment of principal and interest required to repay $193,948 ($200,000 less all scheduled payments up to and including March 1, 2014) over 28 years (the remaining loan term) at an interest rate of 7.5% (the index value of 4.5% on the date the application was received plus the 3% margin). Additional examples of the monthly payment calculation for different non-standard mortgages, such as interest only or negative amortization loans, are provided in the comments to the ATR rule.

• The lender (not a third party agent or broker) receives the borrower's written application for the standard mortgage no later than two months after the non-standard mortgage is "recast." Lenders may rely on RESPA and Regulation X (including any interpretations issued by HUD) in deciding whether a "written application" has been received. Regulation X defines "application" to mean the submission of a borrower's financial information in anticipation of a credit decision relating to a federally related mortgage loan. A two month limit was provided by the CFPB in recognition of the fact that a borrower may not experience payment shock until the recast occurs and to allow time for a borrower to provide the lender with all of the information required by the lender.

• To ensure that only those borrowers with recent positive payment histories are eligible for the non-standard refinancing exception, during the 12 months immediately preceding the lender's receipt of the borrower's written application for the standard mortgage, the borrower shall have made no more than one late payment (i.e., more than 30 days late) on the existing mortgage. Delinquencies of 30 or fewer days are permitted since late payments may occur for many reasons outside of the borrower's control, such as mailing delays, payment crediting errors or payments that are late but within a late fee grace period.

• The borrower shall have made no late payments on the existing mortgage during the six months immediately preceding the lender's receipt of the borrower's written application for the standard mortgage. The CFPB noted that a six-month "clean" payment record indicates a reasonable level of financial stability on the part of the borrower applying for a refinancing and was generally consistent with common industry practice. This is an absolute requirement and the CFPB specifically declined to adopt a rule allowing for extenuating circumstances to avoid a risk analysis for different circumstances.

• A lender must consider whether the borrower's proposed standard mortgage would prevent a likely default on the non-standard mortgage once the loan is recast. The CFPB notes that it would be difficult to impose by regulation a single standard for what constitutes a likely default. Accordingly, the CFPB permits, but does not require, lenders to look to widely-accepted standards for analyzing a borrower's likelihood of default. The CFPB does not believe that this flexible approach requires a lender to consider the borrower's income and assets if, for example, statistical evidence indicates that borrowers who experience a payment shock of the type that the borrower is about to experience have a high incidence of defaulting following the payment shock.

A lender making a loan under the special refinancing exception of the ATR rule may offer to the borrower the same or better rate discounts and other terms that the lender offers to any new borrower, consistent with the lender's documented underwriting practices related to loan pricing, loan term qualifications, or other similar underwriting practices and to the extent not prohibited by applicable State or Federal law. For example, assume that the lender has a documented practice of offering rate discounts to borrowers with credit scores above a certain threshold and the borrower receiving the refinancing has a credit score below this threshold. The lender may, but is not required to, offer the borrower the discounted rate even though the borrower would not normally qualify for that discounted rate, assuming the discounted rate is not prohibited by applicable State or Federal law.

Section 1026.43(e) - Safe harbor and presumption of compliance for Qualified Mortgages. To provide lenders more certainty about their potential liability under the ability to repay standards, the ATR rule provides a "safe harbor" through a conclusive presumption of compliance with the ability to repay requirements for loans that satisfy the definition of a qualified mortgage and are not higher-priced covered transactions. A loan that satisfies these criteria and is a higher-priced covered transaction receives a rebuttable presumption of compliance with the ability to repay requirements. To rebut the presumption of compliance the borrower must prove that at the time the loan was made the borrower's income and debt obligations (including alimony and child support), and the borrower's monthly payment (including mortgage-related obligations) on the covered transaction and on any known simultaneous loans would leave the borrower with insufficient residual income or assets (including any real property attached to the dwelling that secures the loan but not the value of the dwelling itself) to pay living expenses (such as food, clothing, gasoline and health care), including known recurring and material obligations or expenses. The CFPB noted further that, the longer the period of time that the borrower has demonstrated actual ability to repay the loan by making timely payments, without modification or accommodation, after closing or, for an adjustable-rate mortgage, after recast, the less likely the borrower will be able to rebut the presumption based on insufficient residual income and prove that, at the time the loan was made, the lender failed to make a reasonable and good faith determination that the borrower had the reasonable ability to repay the loan.

Qualified mortgage-General definition. The ATR rule generally prohibits loans with negative amortization, interest-only payments, balloon payments, or terms exceeding 30 years and so-called "no-doc" loans, where the lender does not verify income or assets, from being qualified mortgages. Under the ATR rule a loan may qualify as a qualified mortgage in one of three ways. All three of these options require that the loan term must not exceed 30 years and that the qualified mortgage provides for regular periodic payments that are substantially equal (except for subsequent adjustable or step-rate interest rate changes) and does not allow for negative amortization, principal deferral (no interest only loans) or a balloon payment (except for certain balloon payment loans described in Option Three, below). In addition, the total points and fees payable in connection with the loan may not exceed 3% (or a lower threshold for smaller loans, as adjusted annually by the CFPB).

Option One. Under the first option, when the loan can satisfy the general definition, the borrower must also have a total (or "back-end") debt-to income ratio that is less than or equal to 43%, utilizing the standards set forth in Appendix Q to the ATR rule other than with respect the calculation of the monthly payment for mortgage-related obligations on the covered loan and any known simultaneous loan. For purposes of this option, the lender must consider and verify, at a minimum, any income, debt or liability specified in Appendix Q. A lender may also consider and verify other income or debt in accordance with the general ability to repay requirements set forth above, however, such income or debt would not be included in the total monthly debt-to-income ratio determination required by the qualified mortgage rules. The monthly payments for mortgage-related obligations must be calculated based on the maximum interest rate that may apply during the first five years after the date on which the first regular periodic payment will be due and periodic payments of principal and interest that will repay the outstanding principal balance over either the remaining term of the loan as of the date the interest rate adjusts to the maximum interest rate (assuming all required payments were made) or the loan amount over the loan term.

Option Two. Alternatively qualified mortgage status may be achieved under a temporary definition, when the loan can satisfy the requirements of the general definition for a qualified mortgage set forth above, and also satisfy the underwriting requirements of, and is therefore eligible to be purchased, guaranteed or insured by either (1) the GSEs (including any limited-life regulatory entity successor) while operating under Federal conservatorship or receivership (as indicated, for example, by an "Approve/Eligible" or "Accept and Eligible to Purchase" from Desktop Underwriter or Loan Prospector, respectively); or (2) the U.S. Department of Housing and Urban Development, Department of Veterans Affairs, Department of Agriculture or Rural Housing Service. This temporary provision expires on the earlier of January 10, 2021, or, with respect to either Fannie Mae or Freddie Mac (or any succeeding limited-life regulatory entity) the date it ceases to operate under Federal conservatorship or receivership, or, as to the Federal agencies, on the effective date of a rule issued by that Federal agency to define a qualified mortgage. The CFPB created this exemption to provide a transition period and facilitate credit to borrowers with a debt-to-income ratio above 43% and compliance by lenders by promoting widely recognized federally related underwriting standards. Unlike loans that are qualified mortgages under the first option, there are no documentation and verification requirements or a specific payment calculation requirement, as there is no specific monthly debt-to-income ratio threshold to be a qualified mortgage under this temporary provision, except as may be required to be eligible for purchase or guarantee or to be insured by the GSEs or Federal agencies. The CFPB noted that these loans must first satisfy certain payment calculation requirements and repayment ability analyses (which include consideration of a borrower's total monthly debt-to-income ratio) and the

information on which the calculation is based must be documented and verified in order to be purchased or guaranteed by these entities.

Option Three. The third way qualified mortgage status may be achieved is when the loan is originated and held in portfolio by a Small Lender. There are three ways in which a loan originated by a Small Lender may achieve qualified mortgage status. Section 1026.43(e)(5) applies to all loans made by Small Lenders other than balloon payment loans. Section 1026.43(f) applies to balloon payment loans made by Small Lenders who are operating predominantly in rural or underserved areas (as designated by the CFPB) and who made more than 50% of their total covered transactions secured by first liens on properties in counties that are “rural” or “underserved.” Section 1026.43(e)(6) provides a transitional period allowing Small Lenders not operating in rural underserved areas to originate balloon payment loans prior to January 10, 2016, so long as all other requirements of Section1026.43(f) are complied with. These loans are collectively referred to as “Small Lender Loans”.

All Small Lender Loans must conform to the applicable requirements under the general definition of a qualified mortgage except with regard to debt-to-income ratio. In other words, the lender must comply with the points and fee limitations set forth in the general definition of a qualified mortgage and the terms of the Small Lender Loan payment must provide for scheduled payments that are substantially equal, calculated using an amortization period that does not exceed 30 years, that does not permit negative amortization, at a fixed interest rate over a loan term of least five years and no more than 30 years. Although there is no specific debt-to-income ratio requirement for Small Lender Loans, such as the 43% requirement in Option One, lenders must generally consider and verify a borrower’s monthly debt-to-income ratio by verifying the borrower’s income or assets and debt obligations (however, unlike Option One, ***without regard to the standards in Appendix Q***) as under the general ability-to-repay requirements When underwriting the loan the lender is required to take into account the monthly payment for any mortgage-related obligations using the maximum interest rate that may apply during the first five years and periodic payments of principal and interest that will repay the full principal (other than for a balloon payment loan, in which case the balloon payment is excluded and the maximum scheduled payment is used). Based on this verification, the lender must determine that the borrower can make all of the scheduled payments together with the borrower’s monthly payments for all mortgage related obligations from the borrower’s current or reasonably expected income or assets other than the dwelling that secures the loan. Absent a merger or acquisition or supervisory action, a Small Lender Loan must be held for three years in order to maintain qualified mortgage status unless the assignee itself qualifies as a Small Lender eligible to originate the same type of Small Lender Loan. After three years the Small Lender Loan retains its status as a qualified mortgage for the life of the loan and the transferee, and any subsequent transferees, may invoke the presumption of compliance for qualified mortgages.

In summary, as noted above, the Amendments changed the definition of a higher-priced covered transaction if the annual percentage rate exceeds the APOR for a comparable transaction by 3.5% or more, instead of 1.5% or more as in the ATR rule. Without the Amendments, these loans would have been subject to a rebuttable presumption of compliance. Second, the Amendments require Small Lenders to consider the borrower’s debt-to-income ratio or residual income, and to verify the underlying information generally in accordance with Section 1026.43(c). In contrast, Option One requires a lender to calculate the borrower’s debt-to-income ratio according to Appendix Q and specifies that the borrower’s debt-to-income ratio must be 43% or less.

Section 1026.32 - Limitations on Prepayment Penalties, Points and Fees. The treatment of prepayment penalties under the points and fees test for standard and qualified mortgages and for high-cost loans under HOEPA restricts prepayment penalties that may be charged by the current holder of the existing mortgage loan, the servicer acting on behalf of the current holder, or an affiliate of either in a number of ways for all residential mortgage loans. The CFPB believes that these are the entities that would benefit from refinancing loans with prepayment penalties and seeks to deter loan flipping while ensuring access to safe, affordable credit.

For a closed-end credit transaction, prepayment penalty means a charge imposed for paying all or part of the transaction's principal before the date on which the principal is due, other than a waived, bona fide third-party charge that the lender imposes if the borrower prepays all of the transaction's principal sooner than 36 months after closing; provided, however, that interest charged consistent with the monthly interest accrual amortization method is not a prepayment penalty for loans insured by the Federal Housing Administration (FHA) that are closed before January 21, 2015. The CFPB gives the following examples of prepayment penalties: (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 interest accrual amortization used for other payments in the transaction under the terms of the loan contract; (2) a fee, such as an origination or other loan closing cost, that is waived by the lender on the condition that the borrower does not prepay the loan, including a waived bona fide third party charge imposed if the borrower pays all of the loan's principal balance within three years after closing, up to the amount actually paid (any excess that the lender may impose is a prepayment penalty); (3) a minimum finance charge in a simple interest transaction; and (4) computing a refund of unearned interest by a method that is less favorable to the borrower than the actuarial method. Fees imposed for preparing and providing documents when a loan is paid in full are not prepayment penalties when such fees are imposed whether or not the loan is prepaid.

Under the ATR rule, a closed-end, dwelling-secured loan may include a prepayment penalty only if it is a fixed or step-rate, non-higher priced qualified mortgage (no adjustable rate mortgages) and the amount is capped starting at up to 2% in the first two years after closing and up to 1% in third year so that no penalties may be charged after the third year. Additional limitations on prepayment penalties are imposed through the inclusion of the maximum prepayment penalty in the definition of points and fees for qualified mortgages, set forth below.

A prepayment penalty may not be offered unless the lender (or the lender's mortgage broker) also offers the borrower an alternative covered transaction without a prepayment penalty. The alternative covered transaction must have the same type of interest rate (fixed or step-rate) and loan term as the covered transaction with a prepayment penalty that provides for regular periodic payments that are substantially equal (except for subsequent step-rate interest rate changes) and the total points and fees payable in connection with the loan may not exceed 3% (or a lower threshold for smaller loans, as adjusted annually by the CFPB), based on the information known to the lender at the time the transaction is offered. The CFPB noted that at the time a lender offers a borrower an alternative covered transaction without a prepayment penalty, the lender may know the amount of some, but not all, of the points and fees that will be charged for the transaction. Lastly, the lender must have a good faith belief that the borrower likely qualifies for the alternative covered transaction. In making this determination, the lender may rely on information provided by the borrower, even if the information subsequently is determined to be inaccurate. For example, if

the borrower can afford $800 of monthly payments and the lender offers the borrower a fixed-rate mortgage with a prepayment penalty for which monthly payments are $700 and an alternative covered transaction without a prepayment penalty for which monthly payments are $900, this requirement is not met.

In addition, in order to offer prepayment penalties in a transaction utilizing a mortgage broker's services, the lender must have an agreement that the mortgage broker must present the borrower an alternative covered transaction without a prepayment penalty from the lender or another lender, if the transaction offered by the other lender has a lower interest rate or a lower total dollar amount of discount points and origination points or fees. Lenders may comply with this requirement by providing a rate sheet to the mortgage broker that states the terms of such an alternative covered transaction without a prepayment penalty. Likewise, if the lender is a loan originator and the lender presents the borrower a covered transaction to be sold after closing, the lender must present the borrower an alternative covered transaction without a prepayment penalty offered by the assignee or another person, if the transaction offered by the other person has a lower interest rate or a lower total dollar amount of origination discount points and points or fees. These requirements apply only if a loan is closed with a prepayment penalty and is not violated if closed without a prepayment penalty or not closed.

Points and Fees. The following charges, if known at or before closing, are included in the points and fees calculation for a closed-end credit transaction under the ATR rule:

(A) All non-interest items included in the finance charge except the following:

(i) Any premium or other charge imposed in connection with any Federal or State agency program for any guaranty or insurance (i.e., FHA mortgage insurance premiums or guarantee fees for VA or Rural Housing Service loans) that protects the lender against the borrower's default or other credit loss. This rule applies whether the fees are payable before, at, or after closing. Thus, both up-front fees and post-closing periodic payments are excluded.

(ii) For any private guaranty or insurance that protects the lender against the borrower's default or other credit loss:

- If the premium or other charge is payable after closing, the entire amount of such premium or other charge; or
- If the premium or other charge is payable at or before closing (i.e. a single or up-front payment), the portion of any such premium or other charge that is not in excess of the amount payable for FHA insurance (any excess amount is included in points and fees whether paid in cash or financed and whether the insurance is optional or required), provided that the premium or charge is required to be refundable on a pro rata basis and the refund is automatically issued upon notification of the satisfaction of the underlying mortgage loan (if not refundable on a pro rata basis or automatically issued the entire premium is included in the points and fees calculation). For example, assuming a $3,000 private mortgage insurance premium charged on a closed-end mortgage loan is payable at or before closing and 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 FHA premium allowable is $2,000. In this case, the lender could exclude $2,000 from points and fees but would have to include the $1,000 that exceeds the allowable premium. If, however, the $3,000 private mortgage

insurance premium were not required to be refunded on a pro rata basis or if the refund were not automatically issued upon notification of the satisfaction of the underlying mortgage loan, the entire $3,000 premium would be included in points and fees.

(iii) Any bona fide third-party charge not retained by the lender, loan originator, or an affiliate of either, unless the charge is otherwise required to be included in points and fees pursuant to (A)(ii) above for private mortgage insurance premiums, or as explained below, (C) for real estate related fees or (D) for credit insurance premiums. The CFPB noted that, in setting the purchase price for specific loans, Fannie Mae and Freddie Mac make loan-level price adjustments (LLPAs) to offset added risks, such as a high LTV or low credit score, among many other risk factors. Lenders may, but are not required to, increase the interest rate charged to the borrower so as to offset the impact of the LLPAs or increase the costs to the borrower in the form of points to offset the lost revenue resulting from the LLPAs. The CFPB stated that the manner in which lenders respond to LLPAs is better viewed as a fundamental component of how the pricing of a mortgage loan is determined rather than as a third party charge and therefore concluded that points charged to offset LLPAs may not be excluded from points and fees under this provision. However, to the extent that lenders offer borrowers the opportunity to pay points to lower the interest rate that the lender would otherwise charge to recover the lost revenue from the LLPAs, such points may, if they satisfy the requirements of (iv) or (v) below, be excluded from points and fees as bona fide discount points.

(iv) Up to two bona fide discount points paid by the borrower in connection with the transaction, if the interest rate without any discount does not exceed the APOR by more than 1%. For example, assuming a transaction that is a first-lien, purchase-money home mortgage with a fixed interest rate, a 30-year term and the borrower locks in an interest rate of 6% on May 1, 2014 that was discounted from a rate of 6.5% because the borrower paid two discount points and the APOR as of May 1, 2014 for home mortgages with a fixed interest rate and a 30-year term is 5.5%. The lender may exclude two bona fide discount points from the points and fees calculation because the rate from which the discounted rate was derived (6.5%) exceeded the APOR for a comparable transaction as of the date the rate on the transaction was set (5.5%) by only 1%. A bona fide discount point must reduce the interest rate based on a calculation that is consistent with established industry practices (for example, secondary mortgage market transactions) for determining the amount of reduction in the interest rate or time price differential appropriate for the amount of discount points paid by the borrower. For example, a lender may rely on pricing in the to-be-announced (TBA) market for mortgage-backed securities (MBS) to establish that the interest rate reduction is consistent with the compensation that the lender could reasonably expect to receive in the secondary market or compliance with the requirements prescribed in Fannie Mae or Freddie Mac guidelines for interest rate reductions from bona fide discount points.

(v) So long as no discount points have been excluded pursuant to (iv) above, then up to one bona fide discount point paid by the borrower in connection with the transaction if the interest rate without any discount does not exceed the APOR by more than two percentage points. For example, assuming a first-lien, purchase-money home mortgage with a fixed interest rate, a 30-year term and the borrower locks in an interest rate of 6% on May 1, 2014, that was discounted from a rate of 7% because the borrower paid four discount points. Finally, assume that the APOR as of May 1, 2014, for home mortgages with a fixed

interest rate and a 30-year term is 5%. The lender may exclude one discount point from the points and fees calculation because the rate from which the discounted rate was derived (7%) exceeded the APOR for a comparable transaction as of the date the rate on the transaction was set (5%) by only 2%.

(B) All compensation paid directly or indirectly by a borrower or lender to a loan originator (which, as defined, can include a mortgage brokerage, employees hired by either a brokerage or a lender, and independent individual mortgage brokers) that can be attributed to that transaction at the time the interest rate is set, whether paid before, at or after closing. The Amendments exclude from this calculation (i) compensation paid by a consumer to a mortgage broker and already included in points and fees under paragraph (A) above; (ii) compensation paid by a mortgage broker to a loan originator that is an employee of the mortgage broker; and (iii) compensation paid by a lender to a loan originator that is an employee of the lender (the "Loan Origination Exceptions"). The Amendments were adopted to prevent "double-counting" in the calculation. The CFPB deliberately chose, however, not to exclude payments from lenders to mortgage brokers, under what the CFPB termed its "additive" approach. For example, if the consumer paid the lender a $3,000 fee and the lender passed along $1,500 of that amount to a mortgage broker, $4,500 would be included in points and fees. However, if the lender paid the $1,500 to its own employee, because compensation paid to an employee of a lender is not included in points and fees, that amount would be excluded and only the consumer's payment of $3,000 to the creditor would count as points and fees. 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 loan transaction. Loan originator compensation includes the dollar value of compensation that is earned upon closing. The CFPB believes that utilizing the date the interest rate is set is an appropriate time to calculate points and fees, with sufficient certainty so that they know early in the process whether a transaction will be a qualified mortgage or a high-cost mortgage.

(C) All real estate related fees for: (i) title examination, abstract of title, title insurance, property survey, and similar purposes; (ii) preparing loan-related documents, such as deeds, mortgages, and reconveyance or settlement documents, notary and credit-report fees; (iii) property appraisal fees or fees for inspections to assess the value or condition of the property if the service is performed prior to closing, including fees related to pest-infestation or flood-hazard determinations; and (iv) amounts required to be paid into escrow or trustee accounts if the amounts would not otherwise be included in the finance charge (other than amounts held for future payment of taxes) ***unless*** the charge is reasonable and the lender receives no direct or indirect compensation in connection with the charge and the charge is not paid to an affiliate of the lender, (*e.g*. an affiliated title insurer). The fact that a transaction for such services is conducted at arms-length ordinarily should be sufficient to make the charge reasonable. For example, a reasonable fee paid by the borrower to an independent, third-party appraiser may be excluded from the points and fees calculation while the payment for an appraisal performed by an employee of the lender must be included in the points and fees calculation, even though the fee may be excluded from the finance charge if it is bona fide and reasonable in amount. Lastly, if a charge is required to be included in points and fees under this provision, it may not be excluded under (A)(iii) above.

(D) Premiums or other charges payable at or before closing (whether they are paid in cash or financed and whether the insurance or coverage is optional or required) for any credit life, credit disability, credit unemployment, or credit property insurance, or any other life, accident, health, or loss-of-income insurance for which the lender is a beneficiary, or any payments directly or indirectly for any debt cancellation or suspension agreement or contract, whether the amount

represents the entire premium or payment for the coverage or an initial payment. If the first premium is payable at or before closing, that payment is included in points and fees even though the subsequent monthly payments are not. Please note that credit property insurance does not include homeowners' insurance because unlike credit property insurance, homeowners' insurance typically covers not only the dwelling but its contents and protects the borrower's, not the lender's interest in the property. If a charge is required to be included in points and fees under this provision, it may not be excluded under (A)(iii) above.

(E) The maximum prepayment penalty (as defined above) that may be charged or collected under the terms of the mortgage loan.

(F) The total prepayment penalty incurred by the borrower if the borrower refinances the existing mortgage loan with the current holder of the existing loan, a servicer acting on behalf of the current holder, or an affiliate of either. This provision is designed to preclude loan flipping where the refinance by the lender is for the financial gain resulting from prepayment penalties.

When points and fees are calculated. The points and fees definition presents a threshold issue of timing. In general, a charge or fee is "known at or before consummation" if the lender knows at or before closing that the charge or fee will be imposed in connection with the transaction, even if the charge or fee is scheduled to be paid after closing. The time when the charge is actually paid is not relevant. For example, if the lender charges the borrower $400 for an appraisal conducted by an affiliate of the lender, the $400 is included in points and fees, even if the borrower finances it and repays it over the loan term, because the lender knows at or before closing that the charge or fee is imposed in connection with the transaction. By contrast, charges for a subsequent loan modification generally would not be included in points and fees because, at closing, the lender would not know whether a borrower would seek to modify the loan and therefore would not know whether charges in connection with a modification would ever be imposed.

Total loan amount. A loan generally cannot be a qualified mortgage if the points and fees known at or before closing to be paid by the borrower exceed 3% of the total loan amount (or a lower amount for smaller loans). The total loan amount for a closed-end credit transaction is calculated by taking the amount financed and deducting any costs included in real estate related fees (item (C) above), certain insurance premiums (item (D) above) and the total prepayment penalty (item (F) above), that is both included as points and fees and financed by the lender. For example, assuming a $10,000 loan, a $300 appraisal fee, and $400 in prepaid finance charges. If the borrower finances the $300 fee for a lender-conducted appraisal and pays the $400 in prepaid finance charges at closing, the amount financed is $9,900 ($10,000 plus the $300 appraisal fee that is paid to and financed by the lender, less $400 in prepaid finance charges). The $300 appraisal fee paid to the lender is added to other points and fees under (C) above and is therefore deducted from the amount financed ($9,900) to derive a total loan amount of $9,600. If the borrower finances the $300 fee for an appraisal conducted by someone other than the lender or an affiliate, the $300 fee is not included with other points and fees under (C) above and the amount financed is the same as the total loan amount. $9,900 ($10,000 plus the $300 fee for an independently-conducted appraisal that is financed by the lender, less the $400 paid in cash and deducted as prepaid finance charges). In this case, if the borrower also finances a $500 single premium for optional credit unemployment insurance, the amount financed is $10,400 ($10,000, plus the $300 appraisal fee and the $500 insurance premium that is financed by the lender, less $400 in prepaid finance charges). The $300 appraisal fee is not added to other points and fees under (C), however, the $500 insurance premium

is added under (D). The $500 cost is deducted from the amount financed ($10,400) to derive a total loan amount of $9,900.

Section 1026.25 - Record Retention. Lenders are required to retain records that show compliance with the ATR rule for at least three years after closing. Only enough information to reconstruct the required disclosures or other records accurately must be retained. Realistically, because a borrower may assert a violation of the ATR rule as a matter of defense by recoupment or setoff in a foreclosure action at any time, most lenders will retain these records for the life of the loan.

A lender must also retain records that document compliance with the requirement to offer a borrower an alternative covered transaction without a prepayment penalty, unless the loan is closed without a prepayment penalty or not closed. If the loan is originated with a prepayment penalty through a mortgage broker, the lender must retain a record of the lender's alternative covered transaction without a prepayment penalty, such as a rate sheet, and the agreement with the mortgage broker requiring the mortgage broker to present an alternative covered transaction offered by the lender or by another lender.

Violations of the ATR Rule. Under TILA, a borrower who brings an action against a lender for a violation of the ATR rule within three years from when the violation occurs may be able to recover special statutory damages equal to the sum of all finance charges and fees paid by the borrower, unless the lender demonstrates that the failure to comply is not material. This recovery is in addition to: (1) actual damages; (2) statutory damages in an individual action or class action, up to a prescribed threshold; and (3) court costs and attorney fees that would be available for violations of other TILA provisions. After the expiration of the three-year time period, the borrower is precluded from bringing an affirmative claim against the lender. At any time, when a lender or assignee initiates a foreclosure action, a borrower may assert a violation of these provisions "as a matter of defense by recoupment or setoff." There is no time limit on the use of this defense, although the recoupment or setoff of finance charge and fees is limited to the first three years of finance charges and fees paid by the borrower under the mortgage.

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