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Consumer Financial Services

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Forget Plain Vanilla – How About Pickle? Proposed HOEPA Rule Threatens to Curtail Consumer Credit

By Jonathan D. Jaffe, David A. Tallman

It is no secret that the high cost home loan provisions of the Home Ownership and Equity Protection Act of 1994 ("HOEPA") operate as a *de facto* federal usury limit. In large part, this is because HOEPA provides that purchasers of high cost home loans are subject to all claims and defenses that the consumer could assert against the original creditor under both federal and state law.[i] Without a secondary market willing to assume assignee liability risk, high cost home loans have acquired such a toxic reputation that very few lenders choose to originate them and even fewer will finance or buy them. The Dodd-Frank Wall Street Reform and Consumer Protection Act[ii] ("Dodd-Frank") greatly expanded HOEPA's reach by extending its coverage to purchase money mortgages and home equity lines of credit ("HELOCs"); lowering the existing cost thresholds; adding a new prepayment penalty threshold; and revising the APR, finance charge, and points and fees calculations. At the same time, Dodd-Frank targets makers and holders of non-plain vanilla mortgages (*i.e*., those that do not qualify as a qualified mortgage ("QM") or qualified residential mortgage ("QRM")) with enhanced monetary damages, defenses to foreclosure, and risk retention requirements.[iii] Those few lenders who might be able and willing to offer credit outside the plain vanilla confines of the QM/QRM will not have much pricing flexibility to meet their customers' legitimate credit needs before running into pickle-flavored HOEPA.

The Bureau of Consumer Financial Protection (the "CFPB" or the "Bureau") issued a proposed rule last week to implement Dodd-Frank's HOEPA amendments[iv] (the "HOEPA Rule"). To its credit, the Bureau appears to recognize that HOEPA's expanded scope is likely to have a substantially negative impact on consumer access to credit. The Bureau's proposal accordingly attempts to soften some of the harsher – and likely unintended – impacts of the Dodd-Frank amendments. Most notably, to prevent too many loans from triggering the HOEPA rate threshold, the Bureau suggests using a new "transaction coverage rate" (or "TCR") in the rate threshold instead of the APR, in light of the expanded scope of the finance charge and APR in its proposed rule to combine the TILA and RESPA origination disclosures (the "TILA/RESPA Rule")[v]. Unfortunately, the HOEPA thresholds would remain overinclusive, even if the Bureau were to replace the APR with the TCR – particularly in light of the credit-constraining effects of the proposed QM and QRM rules.

If the Bureau is serious about preserving consumer access to credit, it should exercise its authority to make more significant adjustments to the HOEPA thresholds.

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A Primer on High Cost Thresholds

A. General

HOEPA currently applies to any consumer credit transaction that is secured by the consumer's principal dwelling (other than certain "residential mortgage transactions" (e.g.., purchase-money loans), reverse mortgages, or open-end credit) in which either:

1. The annual percentage rate at consummation will exceed by more than 8 percentage points for first-lien loans, or by more than 10 percentage points for subordinate-lien loans, the yield on Treasury securities having comparable periods of maturity to the loan maturity as of the 15th day of the month immediately preceding the month in which the application for the extension of credit is received by the creditor (the "Treasury Yield"); or

2. The total points and fees payable by the consumer at or before loan closing will exceed the greater of 8 percent of the total loan amount, or $400 (adjusted annually for inflation).[vi]

Among other things, the Bureau's proposed HOEPA Rule would: (i) extend HOEPA's coverage to purchase-money mortgage loans and HELOCs, as required under Dodd-Frank; (ii) revise the APR and points and fees thresholds; and (iii) add a new prepayment penalty threshold. Specifically, a high cost home loan would include any consumer credit transaction secured by the consumer's principal dwelling, other than a reverse mortgage, in which:

1. The APR (or, alternatively, the "transaction coverage rate") at consummation of the transaction exceeds the average prime offer rate for a comparable transaction ("APOR") by more than: (i) 6.5 percentage points for transactions secured by a first mortgage on the consumer's principal dwelling (except that the threshold would be 8.5 percentage points, if the dwelling is personal property and the total transaction amount is less than $50,000); or (ii) 8.5 percentage points for transactions secured by a subordinate mortgage on the consumer's principal dwelling;

2. 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 either, exceed: (i) in the case of a loan of $20,000 or more, 5 percent of the total loan amount; or (ii) in the case of a loan of less than $20,000, the lesser of 8 percent of the total loan amount or $1,000 (adjusted for inflation); or

3. The transaction provides for prepayment fees and penalties that: (i) may be imposed more than 36 months after consummation or account opening or (ii) exceed, in the aggregate, more than 2 percent of the amount prepaid.

Because HOEPA loans are subject to expanded TILA liability, and because purchasers of HOEPA loans are subject to all claims and defenses that the consumer could assert against the original creditor, HOEPA loans are essentially unsaleable in the secondary market. Which of course means that few, if any, lenders are willing to make HOEPA loans. Consequently, the HOEPA Rule's lower APR and points and fees thresholds (and to a lesser extent, the new prepayment fee threshold) effectively would significantly tighten the availability of credit.[vii] We discuss each of these thresholds in more detail below.

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B. Rate Threshold

The Bureau's proposal would lower the current APR thresholds from 8 percentage points over the Treasury Yield for first-lien mortgages and 10 percentage points over the Treasury Yield for subordinate-lien mortgages, to 6.5 percentage points over the APOR for most first liens and 8.5 percentage points over the APOR for subordinate liens. As noted above, these changes will almost certainly have a negative impact on the ability of consumers to access residential mortgage credit. However, the impact of the Dodd-Frank amendments on the scope of HOEPA will be even greater than is readily apparent from these numerical changes.

First, TILA and Regulation Z currently permit creditors to exclude from the finance charge – and by extension from the APR – several fees and charges, including most third-party fees.[viii] The CFPB, in its proposed TILA/RESPA Rule, considers expanding the definition of finance charge for closed-end credit to include virtually all fees or charges 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. The only exclusions from this definition would be: (i) fees or charges payable in comparable cash transactions; and (ii) late fees and similar default or delinquency charges, seller's points, amounts required to be paid into escrow accounts if the amounts would not otherwise be included in the finance charge, and property and liability insurance premiums if certain conditions are met. Thus, a large number of fees currently excluded from the finance charge would now be included in the expanded finance charge and APR calculations, such as: (i) closing agent charges; (ii) application fees charged to all applicants for credit whether or not credit is extended; (iii) taxes or fees required by law and paid to public officials relating to security interests; (iv) premiums for insurance obtained in lieu of perfecting a security interest; (v) taxes imposed as a condition of recording the instruments securing the evidence of indebtedness; and (vi) various real-estate related fees, including title insurance premiums.

The CFPB recognizes that without further action, the more inclusive finance charge definition would cause even more closed-end loans to trigger HOEPA protections for high cost loans (as well as protections under state laws similar to HOEPA), a result that Congress may not have considered or intended. The Bureau thus has proposed two alternative HOEPA rate thresholds. The first alternative is to continue to use the APR, letting the chips fall where they may, while the second is to replace the APR with a new "transaction coverage rate" (or "TCR") identical to the APR, except that the TCR only would include charges retained by the creditor, a mortgage broker, or any affiliate of either. Because the proposed expansion of the finance charge definition applies solely to closed-end credit, the Bureau proposes to use the TCR only for closed-end credit (and even then, only if the Bureau decides to implement the finance charge expansion).

While using a TCR instead of the APR would mitigate the impact of the expanded finance charge definition on the HOEPA rate threshold, the finance charge is not the only factor pushing HOEPA ever farther towards "plain vanilla" territory. Not only does Dodd-Frank lower the percentage thresholds and replace the Treasury Yield with the APOR, it also mandates for purposes of the HOEPA threshold that the APR on an adjustable-rate mortgage ("ARM") must be based on the *maximum* interest rate. When the APR may adjust solely in accordance with an index, the maximum rate should be determined by adding the maximum margin to the index value in effect at consummation or account opening. When the APR may adjust for other reasons, the maximum rate must be based on the maximum interest rate that may be imposed during the term of the loan. The current HOEPA APR calculation is not based on the maximum rate, but rather is based on the fully indexed rate (using an index value in effect during the look-back period before consummation and

blended with any introductory rate(s)). The Bureau's proposal to use the maximum rate as the basis for both the APR and TCR represents a significant expansion of HOEPA. It could have particularly dire ramifications for HELOCs, which often provide for an interest rate that may increase to the maximum extent permitted by state law. Requiring the APR or TCR to be based on the maximum rate would hinder lenders' ability to control for interest-rate risk, increase the cost of credit, and curtail the availability of both HELOCs and closed-end ARMs.

C. Points and Fees Threshold

1. General

The proposal also lowers the HOEPA points and fees threshold, and amends the calculation of points and fees to comply with Dodd-Frank's amendments to TILA. It is noteworthy that to be considered a QM/QRM, the points and fees payable in connection with a mortgage loan may not exceed 3 percent of the total loan amount, while, for most residential mortgage loans, the HOEPA Rule establishes a points and fees threshold of only 5 percent of the total loan amount.[ix] In other words, because the same definition of "points and fees" is used for both the HOEPA calculation and the QM/QRM definitions, there will be only a very narrow window between "plain vanilla" and "pickle" no matter what fees are included in the calculation.

It is difficult to assess how much the numerical reduction in the points and fees threshold would expand HOEPA's coverage, because the HOEPA Rule would incorporate new statutory exclusions into the underlying definition of "points and fees." Further, the Bureau once again attempts to mitigate the effect of its proposed expansion of the finance charge by excluding from points and fees on closed-end loans those charges that would be brought into the points and fees calculation solely by operation of the more inclusive finance charge definition. But for a number of reasons, it still seems likely that the proposed points and fees definition will cast a wider net than the existing calculation. For example, under the proposed definition, "points and fees" would include for the first time the maximum prepayment penalties that could be charged under the transaction documents, any prepayment penalties incurred in a same-lender refinance, fees payable after closing, and all loan originator compensation related to a particular transaction.

2. Definition of Points and Fees

HOEPA and Regulation Z currently define "points and fees" to include:

1. All items required to be disclosed under 12 C.F.R § 1026.4(a) and 1026.4(b) (*i.e.*, the finance charge), except interest or the time-price differential;

2. All compensation paid to mortgage brokers;

3. All items listed in 12 C.F.R. §1026.4(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 (these are the fees commonly referred to as 4(c)(7) fees); and

4. Premiums or other charges for credit life, accident, health, or loss-of-income insurance, or debt-cancellation coverage (whether or not the debt-cancellation coverage is insurance under applicable law) that provides for cancellation of all or part of the consumer's liability in the

event of the loss of life, health, or income or in the case of accident, written in connection with the credit transaction.

As discussed below, the Bureau's proposed rule would substantially revise this definition to implement Dodd-Frank's statutory amendments, with some accommodations for open-end credit. While certain aspects of the new definition will be narrower than the current definition (*e.g.*, the new exclusions for bona fide discount points and third-party fees), others will be much broader. The proposed definition would apply both for purposes of the HOEPA high cost home loan threshold and the QM/QRM rules.

a. Closed-End Credit

For closed-end credit, the proposal would define points and fees to include:

1. All items included in the finance charge under 12 C.F.R. § 1026.4(a) and (b), but excluding items described in 12 C.F.R. § 1026.4(c) through (e) (except to the extent otherwise included by the revised points and fees definition) and also excluding:

a. Interest or the time-price differential; and

b. Any premium or other charge for any guaranty or insurance protecting the creditor against the consumer's default or other credit loss to the extent that the premium or charge is:

i. assessed in connection with any Federal or State agency program;

ii. 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,[x] provided that the premium or charge is required to be refundable on a pro rata basis and the refund is automatically issued upon notification of the satisfaction of the underlying mortgage loan; or

iii. payable after consummation;

2. Subject to certain exclusions, all compensation paid directly or indirectly by a consumer or creditor to a loan originator, including a loan originator that is also the creditor in a table-funded transaction;

3. All items listed in 12 C.F.R. § 1026.4(c)(7) (other than amounts held for future payment of taxes), payable at or before consummation, 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 (note that 4(c)(7) charges include many of the charges typically assessed in a residential mortgage transaction);

4. Premiums or other charges payable at or before consummation for any credit life, credit disability, credit unemployment, or credit property insurance, or any other life, accident, health, or loss-of-income insurance, or any payments directly or indirectly for any debt cancellation or suspension agreement or contract;

5. The maximum prepayment penalty that may be charged or collected under the terms of the mortgage loan; and

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6. The total prepayment penalty incurred by the consumer if the consumer refinances the existing mortgage loan with the current holder of the existing loan, a servicer acting on behalf of the current holder, or an affiliate of either.

Note that even beyond the new treatment of prepayment penalties, the broader loan originator compensation provision (described in item 2 above) represents a significant expansion of "points and fees." Under the current definition, only compensation paid to mortgage brokers by borrowers is required to be included in the calculation. However, subject to limited exceptions, the proposed definition of "loan originator" includes *any* person with respect to a particular transaction who for compensation arranges, negotiates, or otherwise obtains an extension of consumer credit for another person (other than the creditor in most circumstances). Thus, the revised points and fees calculation will capture not only borrower-paid broker compensation, but also lender-paid broker compensation, compensation paid from any source to any other loan originator in connection with the transaction, and even compensation paid to the creditor's own employees, even though the borrower's costs for much of this compensation would already be reflected in the interest rate and captured in the APR (or TCR). To demonstrate the reach of this provision, consider loan originator compensation paid to an employee. The proposed definition would include any compensation an employer pays to an employee when the compensation is attributable to the employee's origination of the particular closed-end mortgage, whether paid before or after closing (as long as that compensation can be determined at the time of closing), including bonuses, commissions, awards of merchandise, services, trips, prizes, and even the hourly pay for the actual number of hours worked on the transaction. Once again, the same definition of points and fees is proposed to be used for purposes of the QM / QRM definitions, which means that those calculations also would include all such loan originator compensation.

b. Open-End Credit

For open-end credit, the proposal would define points and fees to include:

1. All items included in the finance charge under 12 C.F.R. § 1026.4(a) and (b) and payable at or before account opening, except interest or the time-price differential;

2. All items listed in 12 C.F.R. § 1026.4(c)(7) (other than amounts held for future payment of taxes) payable at or before account opening, 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;

3. Premiums or other charges payable at or before account opening for any credit life, credit disability, credit unemployment, or credit property insurance, or any other life, accident, health, or loss-of-income insurance, or any payments directly or indirectly for any debt cancellation or suspension agreement or contract;

4. The maximum prepayment penalty that may be charged or collected under the terms of the open-end credit plan;

5. Any fees charged for participation in an open-end credit plan, whether assessed on an annual or other periodic basis; and

6. Any transaction fee, including any minimum fee or per-transaction fee, that will be charged for a draw on the credit line.

The term "points and fees" would not, however, include any fees or charges that the creditor waives at or before account opening unless the fees or charges may be imposed on the consumer after account

opening. Nor does the proposed definition for open-end credit include loan originator compensation. This is because the Bureau determined that loan originator compensation is rarely paid with respect to open-end credit. Further, the calculation does not exclude amounts that would be added to the finance charge by the TILA/RESPA Rule, because the expanded definition would apply only to closed-end credit. Similarly, the proposed definition of points and fees for open-end credit does not exclude mortgage insurance premiums, because mortgage insurance premiums generally are not payable on HELOCs.

c. Exclusions

For both closed-end and open-end credit, points and fees would *not* include:

1. Any bona fide third-party charge not retained by the creditor, loan originator, or an affiliate of either, except mortgage insurance premiums otherwise required to be included in points and fees;

2. Up to 2 bona fide discount points[xi] paid by the consumer in connection with the transaction, if the interest rate for the loan or plan without such points does not exceed by more than 1 percentage point:

    a. The APOR; or

    b. In the case of a transaction secured by personal property, the average rate for a loan insured under Title I of the National Housing Act;[xii] and

3. As an alternative to (2), a single bona fide discount point if the interest rate for the loan or plan without that point does not exceed the APOR (or the National Housing Act average rate, as applicable) by more than 2 percentage points.

D. Prepayment Penalty Threshold

Finally, the Bureau proposes to implement the new Dodd-Frank prepayment penalty threshold, under which a consumer credit transaction will be considered high cost under HOEPA if the transaction provides for prepayment fees and penalties that: (i) may be imposed more than 36 months after consummation or account opening; or (ii) exceed, in the aggregate, more than 2 percent of the amount prepaid. (The proposed definition of prepayment penalty is much broader than the common meaning of the term.[xiii]) The Board correctly notes that this threshold is not likely to have a significant impact on residential mortgage lenders or assignees, because other provisions of the Truth-in-Lending Act will operate to prohibit most prepayment penalties that could exceed this threshold in any event. In particular, HOEPA provides that if a loan is a high cost mortgage, it may not include a prepayment penalty. The Bureau's proposed commentary thus clarifies that the prepayment penalty "threshold" effectively establishes a maximum limit on the term and amount of a prepayment penalty on any transaction that *could* be subject to HOEPA coverage (*i.e.*, a closed- or open-end transaction secured by a consumer's principal dwelling, other than a reverse mortgage transaction). Further, under the QM rule as proposed, 12 C.F.R. § 1026.43(g) would: (i) prohibit prepayment penalties for most closed-end mortgages, unless the transaction is a fixed-rate QM with an APR that falls below certain statutorily prescribed thresholds; and (ii) restrict prepayment penalties even for these QMs to 3 percent of the amount prepaid in the first year, 2 percent in the second year, and 1 percent in the third year.[xiv] The practical effect of the prepayment penalty threshold accordingly appears extremely limited.

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The combination of Dodd-Frank's expansion of HOEPA and the QM/QRM thresholds will almost certainly result in further tightening of credit, even for creditworthy borrowers. The CFPB has proposed to modify both the APR and points and fees thresholds to mitigate this impact, but the Bureau's proposal does not go far enough. Unless the Bureau exercises its discretion to implement more substantial adjustments to the HOEPA thresholds, including with respect to the statutory percentage points for the APR threshold and the definition of "points and fees,"[xv] the residential mortgage market soon will resemble the Neapolitan ice cream from hell – a whole lot of plain vanilla, a very thin band of chocolate, and all the rest pickle.

Comments to the Bureau's proposal must be received on or before September 7, 2012.

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[i] The consumer's right to assert claims and defenses is subject to certain limitations, and it remains an open issue whether consumers may assert affirmative claims against purchasers.
[ii] Pub. L. 111-203, H.R. 4173.
[iii] For more information about the credit-constraining effects of Dodd-Frank, see our previous alert, *Hope You Like Plain Vanilla! Mortgage Reform and Anti-Predatory Lending Act (Title XIV)* (July 8, 2010), available at http://www.klgates.com/hope-you-like-plain-vanilla-07-08-2010/.
[iv] CFPB, Docket No. CFPB-2012-0029, *Proposed Rule - High-Cost Mortgage and Homeownership Counseling Amendments to the Truth in Lending Act (Regulation Z) and Homeownership Counseling Amendments to the Real Estate Settlement Procedures Act (Regulation X)*, available at http://files.consumerfinance.gov/f/201207_cfpb_proposed-rule_high-cost-mortgage-protections.pdf (last accessed July 17, 2012). The HOEPA Rule covers a number of topics we do not address in this Client Alert, including counseling requirements, balloon loan provisions, late charges, and payoff statement fees in connection with HOEPA loans.

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[v] CFPB, Docket No. CFPB-2012-0028, *Proposed Rule - Integrated Mortgage Disclosures under the Real Estate Settlement Procedures Act (Regulation X) and the Truth In Lending Act (Regulation Z)*, available at http://files.consumerfinance.gov/f/201207_cfpb_proposed-rule_integrated-mortgage-disclosures.pdf (last accessed July 17, 2012).
[vi] 12 C.F.R. § 1026.32(a). The dollar trigger for 2012 is $611.
[vii] The Bureau has announced its intent to focus on fair lending violations, and to apply a disparate impact test in doing so. The lower APR and points and fees thresholds under the proposed HOEPA Rule, as well as the tests suggested under the QM and QRM Rules, will almost certainly result in an increased percentage of loan applications being denied. This will be evident through HMDA reports. It remains to be seen whether this will result in general in an increase in the percentage of denials of members of protected classes.
[viii] *Id*. § 1026.4.
[ix] The Bureau also proposes amending the definition of "total loan amount" such that the amount financed is no longer the starting point for the calculation. Instead, the proposal suggests that the "total loan amount" for closed-end credit should be the amount of credit extended at consummation that the consumer is legally obligated to repay, as reflected in the loan contract, less any cost that is both included in points and fees and financed by the creditor (for open-end credit, the "total loan amount" would be the credit limit for the plan when the account is opened).
[x] 12 U.S.C. § 1709(c)(2)(A).
[xi] For this purpose, "bona fide discount point" would have the same meaning as in 12 C.F.R. § 1026.43(e)(3)(iv), which the QM proposed rule would define as any percent of the loan amount of a covered transaction paid by the consumer that reduces the interest rate or time-price differential applicable to the covered transaction based on a calculation that: (i) is consistent with established industry practices for determining the amount of reduction in the interest rate or time-price differential appropriate for the amount of discount points paid by the consumer; and (ii) accounts for the amount of compensation that the creditor can reasonably expect to receive from secondary market investors.
[xii] 12 U.S.C. §§ 1702 *et seq.*
[xiii] The proposed Commentary gives the following examples of prepayment penalties: (i) 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; (ii) a fee, such as an origination or other loan closing cost, that is waived by the creditor on the condition that the consumer does not prepay the loan; (iii) a minimum finance charge in a simple interest transaction; and (iv) computing a refund of unearned interest by a method that is less favorable to the consumer than the actuarial method, as defined in 15 U.S.C. 1615(d).
[xiv] *See* 76 FR 27390, 27472-78 (May 11, 2011).
[xv] *See* 15 U.S.C. § 1602(bb).

Consumer Financial Services Practice Contact List

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

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