



**COMMENTS  
to the  
Consumer Financial Protection Bureau**

**regarding**

**12 CFR Part 1026  
Docket No. CFPB-2016-0013  
RIN 3170-AA59, Doc. No. 2016-06834**

**81 Fed. Reg. 16,074 (Mar. 25, 2016)**

**Truth in Lending Act – Regulation Z  
Rural Mortgage Lending Exceptions for Small Creditors**

**by**

**Americans for Financial Reform, Empire Justice Center, National Association  
of Consumer Advocates**

**&**

**National Consumer Law Center (on behalf of its low income clients)**

**April 25, 2016**

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**1. SUMMARY: The interim one-rural-mortgage threshold for exempting small-lenders from multiple consumer protection rules will harm the public and should be repealed.**

We thank the Consumer Financial Protection Bureau for the opportunity to comment on the recently issued interim rule.<sup>1</sup> These comments are filed by Americans for Financial Reform,<sup>2</sup> the Empire Justice Center,<sup>3</sup> the National Association of Consumer Advocates,<sup>4</sup> and the National Consumer Law Center<sup>5</sup> (on behalf of its low-income clients).

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<sup>1</sup> 81 Fed. Reg. 16074 (Mar. 25, 2016).

<sup>2</sup> **Americans for Financial Reform** (AFR) is a coalition of more than 200 national, state, and local groups who have come together to advocate for reform of the financial industry. Members of AFR include consumer, civil rights, investor, retiree, community, labor, faith based, and business groups. Americans for Financial Reform is a coalition of more than 200 national, state and local groups who have come together to reform the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, faith based and business groups. A list of coalition members is available at <http://ourfinancialsecurity.org/about/our-coalition/>. For questions about these comments, please contact Brian Simmonds Marshall, Policy Counsel.

<sup>3</sup> **Empire Justice** is a New York State, multi-issue, multi-strategy public interest law firm focused on changing the “systems” within which poor and low income families live. Empire Justice Center’s mission is to protect and strengthen the legal rights of people in New York State who are poor, disabled or disenfranchised through: systems change advocacy, training and support to other advocates and organizations, and high quality direct civil legal representation. For questions about these comments, please contact Ellie Pepper, Regional Coordinator – Northeast/HudsonValley.

<sup>4</sup> The **National Association of Consumer Advocates** (NACA) is a non-profit corporation whose members are private and public sector attorneys, legal services attorneys, law professors, and law students, whose primary focus involves the protection and representation of consumers. NACA’s mission is to promote justice for all consumers.

<sup>5</sup> The **National Consumer Law Center®** (NCLC®) is a non-profit Massachusetts corporation specializing in low-income consumer issues, with an emphasis on consumer credit. Since 1969, NCLC has used its expertise in consumer law and energy policy to work for consumer justice and economic security for low-income and other disadvantaged people, including older adults, in the United States. NCLC’s expertise includes policy analysis and advocacy; consumer law and energy publications; litigation; expert witness services, and training and advice for advocates. NCLC works with nonprofit and legal services organizations, private attorneys, policymakers, and federal and state government and courts across the nation to stop exploitive practices, help financially stressed families build and retain wealth, and advance economic fairness. NCLC publishes a series of consumer law treatises including Mortgage Lending, Truth in Lending and Foreclosures. For questions, please contact NCLC attorney Andrew Pizor.

## 2. Introduction

On March 25, 2016,<sup>6</sup> the Consumer Financial Protection Bureau (the “Bureau”) published an interim final rule that redefines the small creditors serving rural and underserved areas who are exempt from certain consumer protections in Regulation Z. The interim final rule dramatically increases the number of lenders who qualify for this exemption. It exempts lenders who do not focus on rural or underserved areas, but have only the most tenuous connection with those areas: any lender that makes just one loan per year in those areas qualifies for the exemption, as long as it has less than \$2 billion in assets and makes no more than 2,000 closed-end first mortgage loans a year.

Under the interim rule this vastly expanded group of lenders will not have to set up escrow accounts when making higher-priced (HPML) or high-cost (HOEPA) mortgage loans, greatly increasing the risk of default. They will be allowed to schedule balloon payments for HOEPA loans and even some HPML and “qualified mortgage” (QM) loans – loans that are deemed so safe that they are exempt from a wide variety of consumer protections. And, because of the ripple effect of the revised definition, it appears that they will not have to obtain appraisals for certain HPMLs.

The rule is far broader than it needs to be. It will allow the market to return to some of the risky lending practices that led to the Great Recession. It will deprive consumers of key protections. We urge the Bureau to narrow the exemption significantly.

Although the specific changes made to the text are simple, they radiate outward to impact many important consumer protections. Before the interim rule became effective, the exemption applied to small creditors making more than half their closed-end, first mortgages in rural or underserved areas. Now, small creditors will need to make only **one** loan in a rural or underserved area.

The new provision will affect QMs, HPMLs, and HOEPA mortgage loans. Upon meeting the newly reduced threshold, a substantially larger group of small creditors will be exempt from:

- the requirement that HPMLs and many HOEPA mortgages come with an escrow account;
- the ban on balloon payments in QMs (including HPMLs that qualify as QMs) and HOEPA loans; and
- the appraisal requirements for certain HPMLs.

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<sup>6</sup> 81 Fed. Reg. 16,074 (Mar. 25, 2016).

The lower threshold will also affect the protections created by the risk-retention rule because the number of secondary-market buyers eligible to purchase loans made under the exemption will increase.<sup>7</sup>

These problems will be compounded if the exemption applies to all loans that creditor makes, rather than being limited to loans made in rural or underserved areas. In addition, the exemption does not appear to be limited to depository institutions or other carefully regulated entities. Instead, every small creditor will qualify—even local con-artists, hard-money lenders, and foreclosure rescue scammers—so long as they are subject to the Truth in Lending Act (TILA).

Based on numbers included in the Bureau’s Federal Register notice, the new, one-mortgage threshold allows about 6,000 additional lenders to make an estimated 1.1 million loans under substantially weaker consumer protections. These numbers may be even higher given the limits of the Bureau’s data.<sup>8</sup> The new rule also reduces the threshold for the approximately 4,000 lenders covered by the previous rule—allowing them to cut back on their lending in rural and underserved areas while retaining the exemption.

These comments summarize the affected regulations, discuss the history and purpose of the small-creditor exemption, and explain why the change to only one loan is both unjustified and problematic. We conclude with suggested alternatives and recommendations for revisiting the new threshold.

### **3. The modified small rural creditor exemption will have a broad impact**

#### **3.1 Summary of the exemption as amended by the interim rule**

Under the interim rule, a creditor is exempt from certain consumer protections if it meets several requirements:

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<sup>7</sup> Reg. Z Offl Interpretations 1026.43(f)(2)(ii)-1. *See* § 3.2.4.

<sup>8</sup> 81 Fed. Reg. at 16,081. The Bureau’s figure of 10,100 is based on data more thoroughly described in 80 Fed. Reg. 59,943, 59,662 (Oct. 2, 2015). There the Bureau explained that it used data from HMDA, call reports, and the Bureau’s Consumer Credit Panel. While the Bureau’s numbers “include appropriate projections made to account for any missing information, for example, any institutions that do not report under HMDA[.]” we question whether the projections can adequately identify the number of small, hard-money lenders who do not report to credit bureaus and may not require state licenses.

- During the preceding year<sup>9</sup> the creditor extended **just one** closed-end mortgage<sup>10</sup> that was secured by a first mortgage on a property located in a rural or underserved area (as defined elsewhere);<sup>11</sup>
- During the same time period, the creditor and its affiliates extended no more than 2,000 closed-end, first mortgages (not including loans held in portfolio);<sup>12</sup> and
- The creditor and its affiliates have less than \$2 billion in assets.<sup>13</sup>

## **3.2 Mechanics of the Exemption: why the amended criteria have such a broad effect**

### **3.2.1 Effect on escrow requirements**

The revised definition has a straightforward effect on escrow requirements for HPMLs. Regulation Z, § 1026.35(b)(1), requires creditors to set up escrow accounts for taxes and insurance when making HPMLs. However, § 1026.35(b)(2)(iii)(A)-(D) creates an exception to this requirement for small creditors who make loans in rural or underserved areas and meet certain other requirements. The interim final rule allows small creditors to qualify for this exception if they make just one loan per year, instead of 50% of their loans, in such an area.

This expanded exception also affects HOEPA loans. The HOEPA regulation, § 1026.32, does not include its own escrow requirement. However, many if not most HOEPA loans meet not only the definition of a HOEPA loan but also the definition of a HPML. (This is because HOEPA loans often exceed the APR trigger that defines a HPML.) Thus, the escrow requirement for HPMLs – along with the newly-expanded exemption for rural/underserved lenders – applies to these HOEPA loans.

### **3.2.2 Effect on balloon payment restrictions**

Section 1026.32(d), prohibits balloon payments for HOEPA loans. However, it creates an exception for loans that meet “the criteria set forth in §§ 1026.43(f)(1)(i) through (vi) and 1026.43(f)(2) . . . .” Section 1026.43(f)(1)(vi) in turn incorporates the requirements of § 1026.35(b)(2)(iii)(A) through (C). Section 1026.35(b)(2)(iii)(A) is the provision that formerly imposed a requirement that a small lender make 50% or more of its loans in a rural or underserved area, but the

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<sup>9</sup> Or either of the preceding two years if the consumer’s loan application was received before April 1<sup>st</sup> of the current year. Reg. Z § 1026.35(b)(2)(iii)(A).

<sup>10</sup> Technically a “covered transaction” as defined by Reg. Z § 1026.43(b)(1).

<sup>11</sup> Reg. Z § 1026.35(b)(2)(iii)(A).

<sup>12</sup> Reg. Z § 1026.35(b)(2)(iii)(B).

<sup>13</sup> Reg. Z § 1026.35(b)(2)(iii)(C).

interim final rule requires just one such loan per year. Under the interim final rule, this greatly expanded group of lenders can now make HOEPA loans with balloon payments.

The change also affects QMs—loans that are deemed so safe that the lender need not comply with a variety of consumer protections. Section 1026.43(e)(2)(i) defines a QM as one that does not include a balloon payment. But, again, there is an exception. If a loan is made by a rural/underserved lender and meets the other QM requirements (plus certain additional requirements relating to the balloon payment), then it will qualify as a QM even if it includes a balloon payment.<sup>14</sup> The expansion of the number of lenders that qualify for the rural/underserved designation means that they can include balloon payments even in their QM loans.

Expanding the definition of QM to allow more of them to include balloon payments affects HPMLs too. A HPML can be a QM.<sup>15</sup> Under the interim final rule, a HPML that otherwise meets the QM requirements may qualify as a QM *despite* including a balloon payment, as long as the loan is made by a small creditor that makes at least one loan in an expanded rural or underserved area.<sup>16</sup>

### 3.2.3 Effect on appraisal requirements

One of the key protections of Regulation Z against predatory mortgage lending is the requirement at § 1026.35(c) that the lender obtain an appraisal for a HPML. However, § 1026.35(c)(2)(i) provides that a HPML that “satisfies the criteria of a QM as defined pursuant to 15 U.S.C. § 1639c” is exempt from the appraisal requirements. This brings us back to the Bureau’s definition of QM in § 1026.35(e) and (f). As discussed in § 3.2.2 the interim final rule now allows more loans with balloon payments to qualify as QMs. Thus, if a balloon-payment HPML meets the other QM requirements, it appears that it will qualify as a QM despite the balloon payment. Since these higher-cost balloon payment loans will now be eligible to be QMs, they will also be exempt from the appraisal requirements, as long as they meet the other QM criteria.

This change can even apply to HOEPA loans: A first mortgage loan that exceeds the average prime offer rate by more than 6.5 points will be a HOEPA loan. That rate will also qualify it as a HPML, thereby subjecting it to the appraisal requirement.

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<sup>14</sup> See Reg. Z § 1026.35(f)(1)(vi), which incorporates § 1026.35(b)(2)(iii)(A), the former 50% requirement.

<sup>15</sup> See § 1026.43(e)(1)(ii) (setting forth rules for QMs that are higher-priced mortgage loans).

<sup>16</sup> Reg. Z § 1026.43(f)(1) (“Notwithstanding paragraph (e)(2) [prohibiting balloon payments in QM loans] of this section, a qualified mortgage may provide for a balloon payment, provided: \* \* \* (vi) The creditor satisfies the requirements stated in §1026.35(b)(2)(iii)(A) [one loan in a rural or underserved area], (B), and (C).”).



But if the loan also meets the QM standards (which do not include any rate cap), then it will be exempt from the appraisal requirements just as a non-HOEPA, balloon-HPML would be.

The effect of the interim final rule on appraisal requirements is not mentioned in the Bureau's announcement of the rule in the Federal Register. If the Bureau did not intend the interim final rule to change appraisal requirements, we strongly recommend that it clarify the rule in this respect.

### **3.2.4 Effect on risk-retention restrictions**

Regulation Z provides that a balloon payment QM loses its QM status if it is transferred on the secondary market.<sup>17</sup> There is a good reason for this rule – by preventing originators from offloading these risky loans onto the secondary market, the rule gives them the incentive to underwrite the loans carefully. The HPML exemption to the escrow requirement also has a risk retention provision: a HPML that is made without an escrow account cannot be subject at consummation to a commitment to sell the loan.<sup>18</sup>

However, there is an exception to these rules for transfers to rural/underserved lenders. A balloon payment QM can be sold to a rural/underserved lender without losing its QM status.<sup>19</sup> And a HPML can be made without an escrow account even if the lender already has a commitment to sell it, as long as the sale is to a rural/underserved lender.<sup>20</sup>

The interim final rule significantly expands the scope of these exceptions to the risk retention rules. By loosening the criteria that a lender must meet to qualify as a rural/underserved lender, the interim final rule increases the number of lenders in this category and thereby increases the number who are able to buy balloon-payment QMs and QMs that are made without escrow. With more buyers available, it will be easier for originators to sell these risky, unaffordable loans, and they are likely to be less diligent in underwriting them.

### **3.2.5 Effect on higher-cost mortgage loans**

The interim rule directly amends the part of Regulation Z addressing higher-cost mortgage loans (HPMLs). A HPML is a closed-end, dwelling-secured mortgage with an annual percentage rate (APR) that exceeds the Average Prime Offer Rate by one of several thresholds:<sup>21</sup>

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<sup>17</sup> Reg. Z § 1026.43(f)(2).

<sup>18</sup> Reg. Z § 1026.35(b)(2)(v).

<sup>19</sup> Reg. Z § 1026.43(f)(2)(ii).

<sup>20</sup> Reg. Z § 1026.35(b)(2)(v).

<sup>21</sup> Reg. Z § 1026.35(a)(1).

- by 1.5 or more percentage points for conforming first mortgages;
- by 2.5 or more percentage points for jumbo first mortgages; or
- by 3.5 or more percentage points for subordinate mortgages.

HPMLs are subject to a number of restrictions that do not apply to loans with lower APRs. Most importantly for these comments, a creditor may not make a HPML without establishing an escrow account for property taxes and insurance. And a creditor may not make a HPML without an appraisal that meets certain standards.<sup>22</sup> In some cases two appraisals are required.<sup>23</sup>

With the interim rule, the Consumer Financial Protection Bureau has created two exemptions from the HPML rule’s protections:

- The escrow-account requirement does not apply to small creditors that make at least one loan in a rural or underserved area.<sup>24</sup>
- The appraisal requirement does not apply to QMs originated by small creditors making at least one loan in a rural or underserved area.<sup>25</sup>

Finally, the interim rule allows a small creditor that makes a HPML that qualifies as a QM to include a balloon payment.<sup>26</sup>

### **3.3 The interim rule will weaken restrictions on high-cost (HOEPA) mortgage loans**

The restrictions on HOEPA mortgage loans are also weakened by the interim rule. A HOEPA loan is one that meets one of several triggers:

- 1) The loan has an APR that exceeds the average prime offer rate by more than:
  - 6.5 percentage points for first mortgages;
  - 8.5 percentage points for first mortgages securing dwellings categorized as personal property and the loan amount is less than \$50,000; or
  - 8.5 percentage points for subordinate-liens.

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<sup>22</sup> Reg. Z § 1026.35(c)(3)

<sup>23</sup> Reg. Z § 1026.35(c)(4)

<sup>24</sup> See § 3.2.1 of these comments

<sup>25</sup> See § 3.2.3 of these comments.

<sup>26</sup> See § 3.2.2 of these comments.

2) The creditor charges points and fees exceeding a level that depends on the loan amount: 5% of the total loan amount for loans of at least \$20,000; or the lesser of 8% or \$1,000 for loans under \$20,000.

3) The loan contract includes a prepayment penalty that allows the creditor to charge a penalty more than 36 months after closing or the penalty may exceed over 2% of the amount prepaid.

If a loan meets this definition, it must comply with a number of requirements designed to protect consumers. Among them is a ban on balloon payments.<sup>27</sup> In addition, if a loan both meets the definition of a high-cost mortgage and exceeds the APR threshold for HPMLs, the escrow and appraisal requirements for HPMLs will also apply.<sup>28</sup> The expansion of the exemption in the HPML rule for rural lenders means that more HOEPA loans are exempt from these requirements.

### **3.4 The interim rule will allow risky loans to be designated as qualified mortgages**

The change in the HPML rule affects the small-creditor exemption from the Qualified Mortgage rule. The QM rule is part of a broader rule requiring creditors to evaluate a consumer's ability to repay a loan. Generally, creditors may not originate a mortgage loan without verifying the consumer's ability to repay the debt. The assessment of ability to repay and verification is presumed where the loan meets the QM standards.<sup>29</sup> This irrebuttable presumption creates a "safe harbor" for qualifying loans. Even if the QM also meets the definition of a HPML or HOEPA loan, it is presumed to have complied with the ability-to-repay requirement,<sup>30</sup> but it is possible – under a high standard – to rebut the presumption.<sup>31</sup>

Many in the mortgage industry consider the QM designation highly desirable—even though the QM requirements are far too weak to constitute a "gold standard" for safety. The QM designation is desirable because it insulates the holder from legal liability for violations of the ability-to-repay requirement.

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<sup>27</sup> 15 U.S.C. 1639(e); Reg. Z § 1026.32(d)(1)(i)

<sup>28</sup> A loan that meets any of the other HOEPA triggers but does not meet the HPML's APR trigger will not be subject to the escrow or appraisal requirements.

<sup>29</sup> Reg. Z § 1026.43(e)(1)(i).

<sup>30</sup> 43(e)(1)(ii)

<sup>31</sup> See Reg. Z 1026.43(e)(1)(ii), Reg. Z Off'l Interpretation § 1026.43(e)(1)(ii)-1. See also National Consumer Law Center, Truth in Lending § 9.3.3.4.2 (8th ed. 2012), *updated* at [www.nclc.org/library](http://www.nclc.org/library) (discussing the presumption of compliance with the ability-to-repay rule).

To be a QM, the creditor and the loan terms must meet a list of requirements:<sup>32</sup>

- No negative amortization;
- No balloon payments;
- Verified and documented income and assets;
- Underwriting based on fully amortizing payments based on the maximum applicable rate during the first five years of the loan;
- A debt-to-income ratio analysis;
- Total points and fees no more than three percent of the total loan amount,<sup>33</sup> with some exclusions for bona fide discount points and FHA loans;<sup>34</sup> and
- A maximum term of thirty years.

One exemption from these requirements is that small creditors are free to make QM loans with balloon payments, so long as they make at least one loan in a rural or underserved area per the new interim rule.<sup>35</sup> Such an exemption is extremely troubling because the heart of the QM designation is the presumption that the creditor has examined the borrower's ability to repay. Yet it is obvious that almost no borrower can afford to make a balloon payment without selling the home or refinancing the debt.

A small creditor that makes a HPML or HOEPA loan with a balloon payment under this exemption not only benefits from the QM designation but also qualifies for an exemption from the appraisal requirements for HPMLs (and HOEPA loans that meet the definition of a HPML).<sup>36</sup> As a result, the borrowers are presumed to be able to repay the balloon payment without selling their house or refinancing the debt.

### **3.5 The escrow-account requirements, appraisal rules, and restrictions on balloon loans are necessary to protect borrowers and the economy.**

The Great Foreclosure Crisis that began in the last decade saw too many loans made with features and poor lending practices that increased the risk of default. Poorly

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<sup>32</sup> See National Consumer Law Center, Truth in Lending § 9.3.3.4.1.1 (8th ed. 2012), *updated at* [www.nclc.org/library](http://www.nclc.org/library) (describing definition of “qualified mortgage”).

<sup>33</sup> This is a Home Ownership and Equity Protection Act term defined in 15 U.S.C. § 1602(aa).

<sup>34</sup> 15 U.S.C. §§ 1602(aa)(1)(C), 1639c(b)(2)(C)(ii).

<sup>35</sup> See § 3.2.2 of these comments.

<sup>36</sup> See § 3.2.3 of these comments.

underwritten mortgage loans triggered the ensuing flood of foreclosures that displaced millions of homeowners, promoted neighborhood blight, drove down housing values, and sparked a severe recession.<sup>37</sup> Balloon payments, loans that did not require the borrower to escrow for property taxes and insurance, and inflated appraisals were among the loan features and practices that contributed to the crisis. A related practice, known as risk-layering, involved making a loan that included more than one risky feature—such as originating a loan with a balloon payment and without an escrow account.

The cost of a loan affects the borrower's ability to repay. The higher the cost, the higher the monthly payment. This is especially problematic for lower-income borrowers and those with poor credit histories, because they are the most likely to be offered more expensive loans via the interest rate, additional fees, or both. That means HPMLs and HOEPA loans with balloon payments and without escrow accounts are particularly subject to default.

Even before the recent foreclosure crisis, researchers looking at loans refinanced in 1999 estimated that balloon payment requirements increased foreclosure-related losses by \$127 million.<sup>38</sup> Other studies have found a substantially higher risk of foreclosure for loans having balloon payments.<sup>39</sup>

Originating HPMLs without escrow accounts also increases the risk of default. When the HPML rule was first adopted, escrow accounts were commonly available

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<sup>37</sup> Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* xv-xvi (Jan. 2011), *available at* [http://fcic-static.law.stanford.edu/cdn\\_media/fcic-reports/fcic\\_final\\_report\\_full.pdf](http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf); U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-11-433, *MORTGAGE FORECLOSURES: DOCUMENTATION PROBLEMS REVEAL NEED FOR ONGOING REGULATORY OVERSIGHT* 1, 41-42 (2011), *available at* <http://www.gao.gov/new.items/d11433.pdf> (describing the effect of foreclosures on communities, local governments, and the national economy).

<sup>38</sup> Roberto Quercia, Michael A. Stegman & Walter R. Davis, Ctr. for Cmty. Capitalism, Kenan Inst. for Private Enter., Univ. of N.C. at Chapel Hill, *The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments* (Jan. 2005).

<sup>39</sup> *See* Morgan J. Rose, Fed. Reserve Bank of Chicago, *Predatory Lending Practices and Subprime Foreclosures—Distinguishing Impacts by Loan Category* 45 (Dec. 2006), *available at* [www.chicagofed.org](http://www.chicagofed.org) (fixed rate refinance subprime loans with both prepayment penalties and balloon payments increase the rate of foreclosure by 227%); Ellen Schloemer, Wei Li, Keith Ernst & Kathleen Keest, Ctr. for Responsible Lending, *Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners* 21 (Dec. 2006), *available at* [www.responsiblelending.org](http://www.responsiblelending.org) (higher risk for foreclosure for adjustable rate loans, loans with balloon payments, loans with prepayment penalties, and limited documentation; loans originated with less than full documentation in 2003 had a 63.7% higher risk of foreclosure).

in the market for prime mortgages but not in the subprime market.<sup>40</sup> This is a problem because consumers in the subprime market often shop based on the monthly payment. Quoting a payment that does not include escrow allows a creditor to offer a deceptively low monthly payment.<sup>41</sup> This, in turn, leads consumers to make unrealistic decisions regarding whether a loan is affordable. According to lending-industry representatives, loans with escrow accounts generally perform better than those without escrow accounts.<sup>42</sup>

The importance of accurately valuing a property should be obvious. An accurate appraisal protects both the creditor and the consumer. The creditor is assured that the collateral will adequately secure the amount of the loan. And the consumer will be able to make accurate decisions based on the value of the home. As the FRB observed when first adopting the HPML rule:

Encouraging an appraiser to overstate or understate the value of a consumer's dwelling causes consumers substantial injury. An inflated appraisal may cause consumers to purchase a home they otherwise would not have purchased or to pay more for a home than they otherwise would have paid. An inflated appraisal also may lead consumers to believe that they have more home equity than in fact they do, and to borrow or make other financial decisions based on this incorrect information.<sup>43</sup>

The Financial Crisis Inquiry Commission extensively documented the extent to which inflated appraisals were used to support refinancings by creating fictitious equity and helping to create a dangerous housing bubble.<sup>44</sup>

Inaccurate appraisals may also affect neighboring properties and others used for “comps” by future appraisers.<sup>45</sup> Recent experience has further shown that the default rate is higher on loans with loan-to-value ratios that exceed 100% (commonly described as “being underwater”).<sup>46</sup>

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<sup>40</sup> 73 Fed. Reg. 44,522, 44,558 (July 30, 2008).

<sup>41</sup> *Id.*

<sup>42</sup> 73 Fed. Reg. 44,522, 44,558 n.95 (July 30, 2008).

<sup>43</sup> 73 Fed. Reg. 44,522, 44,566 (July 30, 2008).

<sup>44</sup> Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* 340, 43, 46, 106, 119-20, 500 (Jan. 2011), *available at* [http://fcic-static.law.stanford.edu/cdn\\_media/fcic-reports/fcic\\_final\\_report\\_full.pdf](http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf).

<sup>45</sup> 73 Fed. Reg. 44,522, 44,566 (July 30, 2008).

<sup>46</sup> Peter Dreier, Saqib Bhatti, et al., *Underwater America* at 5 (undated) (“Underwater homeowners are significantly more likely to default on their mortgages than homeowners with positive equity.”), *available at*

Since the Dodd-Frank Act, a creditor originating a HPML must get a second, independent appraisal for purchase-money mortgages on properties that are being flipped within 180 days of the seller's acquisition of the property.<sup>47</sup> Property flipping scams involve speculators who buy dilapidated residential properties at low prices and resell them to unsophisticated first time home buyers at huge markups.<sup>48</sup> The second-appraisal requirement is necessary to protect both consumers and lenders in such high-risk transactions.

#### **4. The one-mortgage threshold is too low.**

##### **4.1 The one-mortgage threshold will make it easy to avoid the escrow-account requirement, the appraisal requirements, and the limits on balloon loans.**

Under the Interim Rule, the exemption will be available for any mortgage made by a creditor making a single rural mortgage without regard to the location of a particular mortgage. As the Federal Register Notice explains, the approximately 360,000 mortgage loans made by approximately 6,000 small creditors who originate less than half of their mortgages in rural areas will now be exempt from these requirements. By definition, a majority of those 360,000 loans will be in areas that are not rural or underserved, thereby expanding the exemption well beyond its intended purpose.

In addition, because the interim rule lacks appropriate safeguards, it could be easily abused. The sole rural mortgage required under the exemption may secure a \$1 debt. The mortgage may be on a property owned by one of the creditor's employees or directors. Or the creditor could be an unlicensed individual specializing in foreclosure rescue loans subject to HOEPA.

Some argue the exemption is necessary to protect access to credit in rural or underserved areas.<sup>49</sup> Before the interim rule, the exemption was better calculated to doing so. But now, the rule can be interpreted as permitting the creditor to make all of its loans (except one) in highly competitive urban markets.

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[http://diversity.berkeley.edu/sites/default/files/HaasInsitute\\_UnderwaterAmerica\\_PUBLI\\_SH\\_0.pdf](http://diversity.berkeley.edu/sites/default/files/HaasInsitute_UnderwaterAmerica_PUBLI_SH_0.pdf).

<sup>47</sup> 15 U.S.C. § 1639h (as amended by Dodd-Frank).

<sup>48</sup> National Consumer Law Center, Mortgage Lending § 6.5.1 (2d ed. 2014), *updated at* [www.nclc.org/library](http://www.nclc.org/library)

<sup>49</sup> Consumer Fin. Protection Bureau, press release, CFPB Issues Proposal To Facilitate Access To Credit In Rural And Underserved Areas (Jan. 29, 2015), available at <http://www.consumerfinance.gov/about-us/newsroom/cfpb-issues-proposal-to-facilitate-access-to-credit-in-rural-and-underserved-areas/>.

## 4.2 The one-mortgage threshold is contrary to Congressional intent

The one-rural-mortgage standard is not targeted to fulfil Congress’s intent in enacting the Dodd-Frank Act and the Helping Expand Lending Practices in Rural Communities Act (HELPRCA).<sup>50</sup>

Although the HELPRCA gave the Bureau more flexibility in defining the small-rural-lender exemption (by deleting the word “predominantly” from the criteria<sup>51</sup>), Congress did not specifically require the Bureau to broaden that aspect of the definition. What Congress did do was explicitly direct the Bureau to create a process for creditors to petition the Bureau to declare areas “rural,” so they could qualify for the rural-or-underserved exemption.<sup>52</sup>

The Bureau’s decision to adopt a one-mortgage threshold for the “rural or underserved” requirement is in some regards inconsistent with the new petition process, because it makes it essentially unnecessary. There are 10,400 lenders small enough to qualify for the exemption.<sup>53</sup> Before the interim rule, approximately 4,100 of them were expected to qualify for the exemption. The remaining 6,300 did not make enough loans in areas designated as rural. Those creditors could, however, attempt to become eligible for the exemption—without changing where they do business—by petitioning the Bureau under the new process. The interim rule, however, eliminates the need for that process for all but the approximately 300 of these creditors who did not make any loans in rural or underserved areas in 2013.<sup>54</sup> Even those creditors may now claim the exemption without recourse to the petition process by making a single loan in a rural or underserved area.<sup>55</sup>

While the approach the Bureau has taken may reduce administrative burdens, we are seriously concerned that it creates unnecessary dangers for borrowers.

## 4.3 The Bureau has not met the statutory burden for weakening HOEPA’s protections.

The provision banning balloon payments from high-cost loans is set forth in 15 U.S.C. § 1639(e).<sup>56</sup> Because this provision is established by statute, the Bureau has

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<sup>50</sup> Pub. L. 114-94, 129 Stat. 1799.

<sup>51</sup> Pub. L. 114-94, § 89003, 129 Stat. 1799.

<sup>52</sup> Pub. L. 114-94, § 89002, 129 Stat. 1799.

<sup>53</sup> 81 Fed. Reg. 16074, 16081 (Mar. 25, 2016).

<sup>54</sup> *Id.*

<sup>55</sup> *Id.*

<sup>56</sup> “No high-cost mortgage may contain a scheduled payment that is more than twice as large as the average of earlier scheduled payments. This subsection shall not apply when the payment schedule is adjusted to the seasonal or irregular income of the consumer.” 15 U.S.C. § 1639(e).



limited authority to grant exemptions. TILA gives the Bureau broad authority to make adjustments and exceptions to the statutory provisions.<sup>57</sup> But Congress specifically limited the scope of that authority for high-cost loans. In fact, Congress thought these limits were so important that they appear twice in the Act.<sup>58</sup> To make exceptions for high-cost loans, the Bureau must “consider [a list of] factors and publish its rationale at the time a proposed exemption is published for comment . . . .”<sup>59</sup>

The interim rule discusses none of the required factors. And it is unlikely that the Bureau could credibly establish that making high-cost loans with balloon payments is in the best interest of consumers. It is especially unlikely that making balloon loans without escrow accounts or appraisals will benefit consumers.

## **5. The Bureau has not adequately justified the interim threshold, nor has it justified rejecting alternatives to this threshold**

### **5.1 The Bureau’s justifications are not sufficient.**

We are concerned that the Bureau has not adequately justified using a single loan as the new threshold, nor has the Bureau fairly considered alternatives to reducing the threshold so dramatically. Instead, according to the Federal Register, the Bureau has simply declared that “the one-loan test . . . is a reasonable interpretation of” the amendment to TILA.<sup>60</sup>

According to the Bureau’s Federal Register notice, lowering the exemption threshold is necessary for a number of reasons. The most prominent reasons appear to be

- addressing “uncertainty and confusion for creditors that are not currently eligible for the special provisions and exemption[.]”<sup>61</sup> and
- implementing Congressional intent to expand eligibility for small-rural-creditor exemption.<sup>62</sup>

These justifications do not require, however, a move to a single-loan standard. The Bureau could have exercised its authority to require an intermediate threshold below fifty percent but greater than a single loan, or cabined the exemptions based on the criteria listed in Section 5.2, below.

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<sup>57</sup> 15 U.S.C. § 1604(a), (f).

<sup>58</sup> 15 U.S.C. §§ 1604(a), (f), 1639(p)

<sup>59</sup> 15 U.S.C. § 1604(f). *See also* 15 U.S.C. § 1639(p) (listing additional factors).

<sup>60</sup> 81 Fed. Reg. 16,074, 16079 (Mar. 25, 2016)

<sup>61</sup> 81 Fed. Reg. 16,074, 16077-78 (Mar. 25, 2016)

<sup>62</sup> *Id.*

Section 1639d(c) says: “The Bureau may, by regulation, exempt from the requirements of subsection (a) a creditor that [meets the listed criteria].”<sup>63</sup> The word “may” plainly makes optional the exercise of this authority. The Bureau is not required to grant any exemptions. The criteria in paragraphs (1) through (4) of subsection (c) describe the limits of the Bureau’s authority. The Bureau may only exempt creditors meeting the listed criteria. The phrase “by regulation” means that, if the Bureau chooses to exercise the authority granted by subparagraph (c), it may only do so by issuing a regulation. Before Congress amended the statute, the first criterion was that the creditor “operates predominantly in rural or underserved areas[.]”<sup>64</sup> Under the prior law, if the Bureau chose to exercise the exemption authority, it could only do so for creditors operating “predominantly” in rural or underserved areas. With the amendment, the Bureau *may* exempt creditors that operate in rural or underserved areas but do not do so predominantly. But, after amendment, the Bureau is still not required to do so.

The Bureau suggests that creditors not currently eligible for the exemption would be confused and “may mistakenly believe that the amendments to TILA automatically broadened the regulatory exemption and may” violate Regulation Z based on this misperception of the law.<sup>65</sup> However, the text of the law is clear that the authority must be exercised by adopting a regulation. So any creditor reading the statute would be on notice that it must read the Bureau’s regulations to determine whether the Bureau has created any exemptions.

There is little legislative history for the Helping Expand Lending Practices in Rural Communities Act.<sup>66</sup> What little there is suggests that Congress was principally concerned with ensuring that rural counties were properly so designated. Based on the plain text of the statute, as amended, and the legislative history of the amendment, deletion of the word “predominantly” should have been interpreted as a modest expansion of the Bureau’s discretion in this area. While a single loan may be a semantically reasonable interpretation of the statute, as amended, so would a range of other higher thresholds.

Although the notice commits that the Bureau will continue to monitor the market for negative effects,<sup>67</sup> we suggest there is already ample data on the negative effects of lending without escrow accounts, of balloon payments, of poor appraisal practices, and of risk layering in HPML and HOEPA mortgages.<sup>68</sup>

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<sup>63</sup> 15 U.S.C. § 1639d(c).

<sup>64</sup> 15 U.S.C. § 1639d(c)(1) (pre-amendment).

<sup>65</sup> *Id.*

<sup>66</sup> Public Law 114-94, 129 STAT. 1799.

<sup>67</sup> 81 Fed. Reg. 16,074, 16,079 (Mar. 25, 2016).

<sup>67</sup> 81 Fed. Reg. 16,074, 16,079 (Mar. 25, 2016).

<sup>68</sup> *See* § 3.5 of these comments

For the reasons described more fully in Section 4, we urge the Bureau to reconsider its selection of the one-loan threshold. The Bureau should choose a numerical threshold that shows that the lender has a significant level of lending in rural or underserved communities—at least enough of a presence to have developed experience about the community’s needs. The Bureau could also consider other indications of a lending presence, such as a branch office in a rural or underserved community, or a special lending program that meets needs that particularly affect such communities.

## **5.2 There are several alternatives the Bureau should consider.**

In addition to a higher threshold, there are a number of alternatives that would mitigate the risk of lowering the rural/underserved lending threshold. These alternatives would still protect consumers while addressing the concerns of law-abiding, small creditors:

- Limit the exemption to depository institutions. Such creditors are subject to supervision, which will somewhat mitigate the risk to borrowers. And they are more likely than hard-money lenders to offer affordable, properly underwritten credit.
- Exclude HOEPA loans from the scope of the exemption. HOEPA loans are so expensive that they should be presumed unaffordable and unduly risky for all but the wealthiest borrowers.
- Limit the balloon-loan exemption to loans made in rural or underserved areas. Extending the exemption to balloon loans in well-served areas irrationally privileges loans that market forces would otherwise discourage.
- Exclude the appraisal rule from the scope of the exemption. The Bureau did not mention the appraisal rule when announcing the interim rule, leaving unclear the Bureau’s analysis of the impact of this element of the revision. Making a mortgage without an appraisal that meets USPAP standards is irresponsible and should never be excused. Requiring a second appraisal for a property that is being flipped is common sense. The cost of appraisals is too small to justify an exemption. The cost of lending based on a bad appraisal is far higher.

Each of these changes would reduce the risk created by the newly lowered threshold. Adopting them in combination would be better.

**6. The Bureau must carefully monitor the performance of exempt loans to determine whether the low threshold raises risks to consumers and mortgage holders.**

**6.1 When revisiting the one-mortgage threshold in the future, consider the value of experience in rural lending.**

While we remain concerned about these exemptions, we are pleased that Bureau plans to reconsider the interim threshold as more data becomes available. As the Bureau does so, we encourage it to weigh the value of having significant experience underwriting and servicing loans made in rural areas.

If there is a policy rationale for exempting mortgages in rural and underserved areas from certain requirements, that rationale is based on the unique characteristics of those geographic markets. The reduced threshold in the interim rule, however, means that a small creditor located in an urban area will be considered a rural lender regardless of its understanding of the rural market. That increases the risk to the borrower, the lender, and anyone purchasing the loan.

Rural consumers have costs associated with homeownership that those located in more urban areas do not have to consider. Rural homeowners are usually required to maintain private sewer systems, do not have municipal garbage pick-up services, must bear the cost of plowing a driveway that is usually much longer than those in suburbia, and must bear the cost of maintaining a well or other private water supply. The cost of heating can be significantly different in rural areas. Franklin County, New York, for example, is the coldest climate zone in the United States, one of three counties in New York State with the highest Heating Degree Days,<sup>69</sup> and has the highest heating costs in the state. Homeowners there are most likely to use heating oil or propane for their heating source, and, like other rural communities, often do not have access to natural gas service. Given the isolated location, rural homeowners are forced to pay higher delivery charges than their urban counterparts.

These all add up to cost burdens that should be considered when underwriting a mortgage. Creditors within rural areas will know to take these costs into account. A creditor that makes only one loan in a rural area probably will not. More experienced lenders will be better able to comply with the spirit of the ability-to-

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<sup>69</sup> Heating degree days are defined relative to a base temperature—the outside temperature above which a building needs no heating. Heating degree day (HDD) is a measurement designed to reflect the demand for energy needed to heat a building. It is derived from measurements of outside air temperature. The heating requirements for a given structure at a specific location are considered to be directly proportional to the number of HDD at that location. A similar measurement, cooling degree day (CDD), reflects the amount of energy used to cool a home or business.

repay requirement, and they are more deserving of the presumption of compliance that comes with the QM designation.

We are similarly concerned that the one-mortgage threshold will drive loan volume from experienced small rural lenders in favor of inexperienced urban lenders looking for a quick loan or two to make the threshold. Consider the example of Elizabethtown, New York (population 1,163 according to the 2010 census). Elizabethtown is a small rural town in upstate New York. There is one bank and one credit union in Elizabethtown, and both make mortgages. While the credit union has been active since just 2005, the bank opened in Elizabethtown in 1961. The bank is well known and is considered the local “go to” for mortgages. This bank most likely fits the criteria to be considered a small creditor and underwrites mortgages for homebuyers in rural areas. The majority of the mortgages it underwrites are in rural areas and, based on its 2015 financial report, it appears to have originated less than 100 mortgages in that calendar year.

If the one-mortgage threshold draws in urban lenders, this could pull the already small customer base away from the local bank, which has the local knowledge to best serve homeowners in their communities. Furthermore, rural banks are already under significant financial pressures, which loss of mortgage volume could exacerbate. While we encourage more options for rural homebuyers, we are concerned that the interim rule will be counterproductive and will reduce the customer base for the well-known small creditor that is deeply invested in the area and able to best serve local customers.

## **6.2 Significant numbers of non-rural balloon loans or non-escrow loans may indicate abuse of the exemption.**

The interim rule makes the rural exemption available to any mortgage made by a qualifying creditor without regard to the location of a particular mortgage. As the Bureau’s Statement explains, under the Interim Rule, that means the approximately 360,000 portfolio loans made by approximately 6,000 small creditors who originate less than half of their mortgages in rural areas will now be exempt from these requirements. By definition, a majority of those 360,000 loans will be in areas that are not rural or underserved.

The Bureau should carefully monitor the non-rural mortgages made pursuant to the revised exemption. If significant numbers of non-rural mortgages are originated to have the risky features permitted by this rule, that data would suggest that the exemption is being used to circumvent the HPML, HOEPA, and QM rules outside of rural areas.

When making decisions based on the data gathered over the next year, the Bureau should remember that it may take several years to detect the danger of poor underwriting concealed by the QM label, balloon payments, poor appraisals, and the

lack of an escrow account. These problems may not be manifest in the first year of the loan. So the lack of data in the next few years should not be taken as proof that the rule is harmless.

### **6.3 Ensure that exempt creditors continue to underwrite for ability to repay and obey all other consumer-protection requirements, despite the exemption.**

The one-rural-mortgage threshold is particularly concerning because it expands the exemption from consumer protections for HPMLs and HOEPA mortgages. As the Bureau suggests in the Federal Register, creditors may be confused by the scope of these exemptions.<sup>70</sup> Therefore, the Bureau and other bank supervisory agencies should continue to emphasize that there is no exemption from the duty to properly underwrite all extensions of credit. Nor do the exemptions extend to the duty to properly and accurately disclose the terms of credit. The Bureau should also take action against creditors—regardless of size—when they make unaffordable, deceptive, or abusive loans.

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<sup>70</sup> 81 Fed. Reg. 16,074, 16,077 (Mar. 25, 2016).