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**BUREAU OF CONSUMER FINANCIAL PROTECTION**

**12 CFR Part 1026**

**[Docket No. CFPB-2015-0004]**

**RIN 3170-AA43**

# Amendments Relating to Small Creditors and Rural or Underserved Areas Under the Truth in Lending Act (Regulation Z)

**AGENCY:** Bureau of Consumer Financial Protection.

**ACTION:** Proposed rule with request for public comment.

**SUMMARY:** The Bureau of Consumer Financial Protection (Bureau) proposes amendments to certain mortgage rules issued in 2013. The proposed rule revises the Bureau's regulatory definitions of small creditor, and rural and underserved areas, for purposes of certain special provisions and exemptions from various requirements provided to certain small creditors under the Bureau's rules.

**DATES:** Comments must be received on or before March 30, 2015.

**ADDRESSES:** You may submit comments, identified by Docket No. CFPB-2015-0004 or RIN 3170-AA43, by any of the following methods:

- *Federal eRulemaking Portal*: http://www.regulations.gov. Follow the instructions for submitting comments.
- *Email*: FederalRegisterComments@cfpb.gov. Include CFPB-2015-0004 AND/OR RIN 3170-AA43 in the subject line of the message.
- *Mail*: Monica Jackson, Office of the Executive Secretary, Consumer Financial Protection Bureau, 1700 G Street, NW, Washington, DC 20552.

- *Hand Delivery/Courier*: Monica Jackson, Office of the Executive Secretary, Consumer Financial Protection Bureau, 1275 First Street, NE, Washington, DC 20002.

*Instructions*: All submissions should include the agency name and docket number or Regulatory Information Number (RIN) for this rulemaking. Because paper mail in the Washington, DC area and at the Bureau is subject to delay, commenters are encouraged to submit comments electronically. In general, all comments received will be posted without change to http://www.regulations.gov. In addition, comments will be available for public inspection and copying at 1275 First Street, NE, Washington, DC 20002, on official business days between the hours of 10 a.m. and 5 p.m. Eastern Time. You can make an appointment to inspect the documents by telephoning (202) 435-7275.

All comments, including attachments and other supporting materials, will become part of the public record and subject to public disclosure. Sensitive personal information, such as account numbers or Social Security numbers, should not be included. Comments generally will not be edited to remove any identifying or contact information.

**FOR FURTHER INFORMATION CONTACT:** Amanda Quester, Senior Counsel, or Paul Ceja, Senior Counsel and Special Advisor, Office of Regulations, at (202) 435-7700.

**SUPPLEMENTARY INFORMATION:**

**I. Summary of the Proposed Rule**

In January 2013, the Bureau issued several final rules concerning mortgage markets in the United States (2013 Title XIV Final Rules), pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Public Law 111-203, 124 Stat. 1376 (2010).[1] The Bureau has clarified and revised those rules over the past two years. The purpose of those updates was to address important questions raised by industry, consumer groups, or other stakeholders. The Bureau has also indicated that it would revisit the Bureau's regulatory definitions of small creditor and rural and underserved areas promulgated in those rules and related amendments through study and possibly through additional rulemaking. For example, in promulgating a temporary two-year transition period in which certain small creditors are permitted to make balloon-payment qualified mortgages in its May 2013 ATR Final Rule, the Bureau stated that it would study, during that transition period, whether the rural and underserved definitions should be adjusted.[2] Similarly, the Bureau solicited comments on the small creditor definition in a proposal amending other regulatory provisions.[3]

The Bureau is now proposing several additional amendments to the 2013 Title XIV Final

[1] Specifically, on January 10, 2013, the Bureau issued Escrow Requirements Under the Truth in Lending Act (Regulation Z), 78 FR 4725 (Jan. 22, 2013) (January 2013 Escrows Final 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), 78 FR 6855 (Jan. 31, 2013) (2013 HOEPA Final Rule), and Ability-to-Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z), 78 FR 6407 (Jan. 30, 2013) (January 2013 ATR Final Rule). The Bureau concurrently issued a proposal to amend the January 2013 ATR Final Rule, which was finalized on May 29, 2013. *See* 78 FR 6621 (Jan. 30, 2013) (January 2013 ATR Proposal) and 78 FR 35429 (June 12, 2013) (May 2013 ATR Final Rule). On January 17, 2013, the Bureau issued the Real Estate Settlement Procedures Act (Regulation X) and Truth in Lending Act (Regulation Z) Mortgage Servicing Final Rules, 78 FR 10901 (Feb. 14, 2013) (Regulation Z) and 78 FR 10695 (Feb. 14, 2013) (Regulation X). On January 18, 2013, the Bureau issued the Disclosure and Delivery Requirements for Copies of Appraisals and Other Written Valuations Under the Equal Credit Opportunity Act (Regulation B), 78 FR 7215 (Jan. 31, 2013) and, jointly with other agencies, issued Appraisals for Higher-Priced Mortgage Loans, 78 FR 10367 (Feb. 13, 2013) (January 2013 Interagency Appraisals Final Rule). On January 20, 2013, the Bureau issued the Loan Originator Compensation Requirements under the Truth in Lending Act (Regulation Z), 78 FR 11279 (Feb. 15, 2013).

[2] May 2013 ATR Final Rule; *see also* Amendments to the 2013 Mortgage Rules Under the Equal Credit Opportunity Act (Regulation B), Real Estate Settlement Procedures Act (Regulation X), and the Truth in Lending Act (Regulation Z), 78 FR 60382 (Oct. 1, 2013) (September 2013 Final Rule) (extending application of the temporary two-year transition period to high-cost mortgages).

[3] Amendments to the 2013 Mortgage Rules Under the Truth in Lending Act (Regulation Z), 79 FR 25730 (May 6, 2014).

Rules to revise Regulation Z regulatory provisions and official interpretations relating to escrow requirements for higher-priced mortgage loans under the Bureau's January 2013 Escrows Final Rule and ability-to-repay/qualified mortgage requirements under the Bureau's January 2013 ATR Final Rule and May 2013 ATR Final Rule.[4] The Bureau's proposal would also affect requirements under the Bureau's 2013 HOEPA Final Rule.[5] The Bureau's proposal reflects feedback from stakeholders regarding the Bureau's definitions of small creditor and rural and underserved areas, as those definitions relate to special provisions and certain exemptions to requirements provided to small creditors under the Bureau's aforementioned rules.

Specifically, the Bureau proposes the following with regard to the definitions of small creditor and rural and underserved areas (as currently provided in §§ 1026.35(b)(2)(iii)(A), (B), (C), and (D), and 1026.35(b)(2)(iv)(A) and (B) and commentary, and cross-referenced in §§ 1026.43(e)(5) and (e)(6), 1026.43(f)(1) and (f)(2) and commentary, and § 1026.32(d)(1)(ii)(C)):

- Raising the loan origination limit for determining eligibility for small-creditor status (based on the preceding calendar year's originations of the creditor and its affiliates) from 500 originations of covered transactions secured by a first lien, to 2,000 such originations, and excluding originated loans held in portfolio by the creditor and its affiliates from that limit. The Bureau also proposes to provide a grace period from calendar year to calendar year to allow a creditor that exceeded the origination limit in

[4] *See also* 2013 September Final Rule.
[5] The January 2013 Interagency Appraisals Final Rule provides an exemption from the requirement to obtain a second appraisal for certain higher-priced mortgage loans if the loan is secured by a property in a "rural county." This proposed rule would not affect the scope of that exemption because it would not change the counties that are defined as "rural" under § 1026.35(b)(2)(iv)(A).

the preceding calendar year to operate, in certain circumstances, as a small creditor with respect to applications received prior to April 1 of the current calendar year.

- Including in the calculation of the asset limit for small-creditor status (*i.e.*, less than $2 billion (adjusted annually) in assets as of the end of the preceding calendar year) the assets of the creditor's affiliates that originate mortgage loans. The Bureau also proposes to add a grace period to the annual asset limit, similar to the grace period added to the origination limit, to allow a creditor that exceeded that threshold in the preceding calendar year to operate, in certain circumstances, as a small creditor with respect to applications received before April 1 of the current calendar year.
- Adjusting the time period used in determining whether a creditor is operating predominantly in rural or underserved areas (*i.e.*, whether the creditor extended more than 50 percent of its total first-lien covered transactions secured by properties located in rural or underserved areas) from any of the three preceding calendar years to the preceding calendar year. As with the origination and asset limits for small-creditor status, the Bureau proposes to add a grace period to allow a creditor that fails to meet this threshold in the preceding calendar year, to continue operating, in certain circumstances, as if it had met this threshold with respect to applications received before April 1 of the current calendar year.
- Amending the current exemption under § 1026.35(b)(2)(iii)(D)(*1*) provided to small creditors that operate predominantly in rural or underserved areas from the requirement for the establishment of escrow accounts for higher-priced mortgage loans, to prevent creditors that are currently ineligible for the exemption, but that might qualify if the proposed rule is finalized, from losing eligibility for the exemption because they

established escrow accounts due to requirements under the current rule prior to the proposed changes in this rulemaking taking effect.

- Expanding the definition of rural to include either: (1) a county that meets the current definition of rural county, or (2) a census block that is not in an urban area as defined by the U.S. Census Bureau (Census Bureau).
- Conforming, through technical changes, the definition of "underserved" to the proposals discussed above. The substance of the "underserved" definition would remain the same.
- Adding two new safe harbor provisions related to the rural or underserved definition for certain automated tools that: (1) may be provided on the Bureau's Web site to allow creditors to determine whether properties are located in rural or underserved areas, or (2) may be provided on the Census Bureau's Web site to assess whether a particular property is located in an urban area according to the Census Bureau's definition. The Bureau also proposes to maintain the current safe harbor for lists of rural and underserved counties provided by the Bureau, with technical changes. The Bureau also proposes to add commentary clarifying the circumstances under which U.S. territories will be included on the lists.
- Extending the temporary two-year transition period that allows certain small creditors to make balloon-payment qualified mortgages (§ 1026.43(e)(6)) and balloon-payment high-cost mortgages (§ 1026.32(d)(1)(ii)(C)), regardless of whether they operate predominantly in rural or underserved areas to certain covered transactions for which the application was received before April 1, 2016.

## II. Background

In response to an unprecedented cycle of expansion and contraction in the mortgage market that sparked the most severe U.S. recession since the Great Depression, Congress passed the Dodd-Frank Act, which was signed into law on July 21, 2010. In the Dodd-Frank Act, Congress established the Bureau and generally consolidated the rulemaking authority for Federal consumer financial laws, including the Truth in Lending Act (TILA) and the Real Estate Settlement Procedures Act, in the Bureau.[6] At the same time, Congress significantly amended the statutory requirements governing mortgage practices, with the intent to restrict the practices that contributed to and exacerbated the crisis.[7]

Under the statute, most of these new requirements would have taken effect automatically on January 21, 2013 if the Bureau had not issued implementing regulations by that date.[8] To avoid uncertainty and potential disruption in the national mortgage market at a time of economic vulnerability, the Bureau issued several final rules (the 2013 Title XIV Final Rules) in a span of less than two weeks in January 2013 to implement these new statutory provisions and provide for an orderly transition. These final rules include the January 2013 ATR Final Rule, the January 2013 Escrows Final Rule, the 2013 HOEPA Final Rule, and the January 2013 Interagency Appraisals Final Rule. Most of the mortgage rules released in January 2013 became effective on January 10, 2014.

[6] *See*, *e.g.*, sections 1011 and 1021 of the Dodd-Frank Act, 12 U.S.C. 5491 and 5511 (establishing and setting forth the purpose, objectives, and functions of the Bureau); section 1061 of the Dodd-Frank Act, 12 U.S.C. 5581 (consolidating certain rulemaking authority for Federal consumer financial laws in the Bureau); section 1100A of the Dodd-Frank Act (codified in scattered sections of 15 U.S.C.) (similarly consolidating certain rulemaking authority in the Bureau). *But see* Section 1029 of the Dodd-Frank Act, 12 U.S.C. 5519 (subject to certain exceptions, excluding from the Bureau's authority any rulemaking authority over a motor vehicle dealer that is predominantly engaged in the sale and servicing of motor vehicles, the leasing and servicing of motor vehicles, or both).

[7] *See* title XIV of the Dodd-Frank Act, Public Law 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of 12 U.S.C., 15 U.S.C., and 42 U.S.C.).

[8] *See* section 1400(c) of the Dodd-Frank Act, 15 U.S.C. 1601 note.

Concurrent with the January 2013 ATR Final Rule, on January 10, 2013, the Bureau issued the January 2013 ATR Proposal, which the Bureau adopted on May 29, 2013 in the May 2013 ATR Final Rule.[9] The Bureau has issued additional corrections, revisions, and clarifications to the provisions adopted by the Bureau in the 2013 Title XIV Final Rules and the May 2013 ATR Final Rule over the past two years.[10] This proposal concerns additional revisions to the 2013 Title XIV Final Rules related to provisions regarding small creditors and rural and underserved areas.

## III. Legal Authority

The Bureau is issuing this proposed rule pursuant to its authority under TILA and the Dodd-Frank Act. Section 1061 of the Dodd-Frank Act transferred to the Bureau the "consumer financial protection functions" previously vested in certain other Federal agencies, including the Board of Governors of the Federal Reserve System (Board). The term "consumer financial protection function" is defined to include "all authority to prescribe rules or issue orders or guidelines pursuant to any Federal consumer financial law, including performing appropriate

[9] 78 FR 6621 (Jan. 30, 2013); 78 FR 35429 (June 12, 2013) (providing a two-year transition period during which small creditors that do not operate predominantly in rural or underserved areas can offer balloon-payment qualified mortgages if they hold the loans in portfolio). In May 2013, the Bureau also finalized amendments to the January 2013 Escrows Final Rule. Amendments to the 2013 Escrows Final Rule under the Truth in Lending Act (Regulation Z), 78 FR 30739 (May 23, 2013) (May 2013 Escrows Final Rule).

[10] *See, e.g.*, 78 FR 44685 (July 24, 2013) (clarifying, among other things, which mortgages to consider in determining small servicer status and the application of the small servicer exemption with regard to servicer/affiliate and master servicer/subservicer relationships); 78 FR 45842 (July 30, 2013); 78 FR 60382 (Oct. 1, 2013) (revising, among other things, two exceptions available to small creditors operating predominantly in "rural" or "underserved" areas, pending the Bureau's reexamination of the underlying definitions); 78 FR 62993 (Oct. 23, 2013) (clarifying the specific disclosures that must be provided before counseling for high cost mortgages can occur and proper compliance regarding servicing requirements when a consumer is in bankruptcy or sends a cease communication request under the Fair Debt Collection Practice Act). In the fall of 2014, the Bureau also made further amendments to the 2013 mortgage rules related to nonprofit entities and provided a cure mechanism for the points and fees limit that applies to qualified mortgages. 79 FR 65300 (Nov. 3, 2014).

functions to promulgate and review such rules, orders, and guidelines."[11] Title X of the Dodd-Frank Act, including section 1061 of the Dodd-Frank Act, along with TILA and certain subtitles and provisions of title XIV of the Dodd-Frank Act, are Federal consumer financial laws.[12]

*A. TILA-Specific Statutory Grants of Authority*

As discussed in more detail in the section-by-section analysis below, TILA as amended by the Dodd-Frank Act provides two specific statutory bases for the proposals in the Bureau's proposed rule. TILA section 129D(c) authorizes the Bureau to exempt, by regulation, a creditor from the requirement (in section 129D(a)) that escrow accounts be established for higher-priced mortgage loans if the creditor operates predominantly in rural or underserved areas, retains its mortgage loans in portfolio, does not exceed (together with all affiliates) a total annual mortgage loan origination limit set by the Bureau, and meets any asset size threshold, and any other criteria, the Bureau may establish. TILA section 129C(b)(2)(E) authorizes the Bureau to provide, by regulation, that certain balloon-payment mortgages originated by small creditors receive qualified mortgage status, even though qualified mortgages are otherwise prohibited from having balloon-payment features. The creditor qualifications under TILA section 129C(b)(2)(E)(iv) are essentially the same as those for the higher-priced mortgage loan escrow exemption, including operating predominantly in rural or underserved areas, together with all affiliates not exceeding a total annual mortgage loan origination limit set by the Bureau,

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[11] Dodd-Frank Act section 1061(a)(1)(A), 12 U.S.C. 5581(a)(1)(A).

[12] Dodd-Frank Act section 1002(14), 12 U.S.C. 5481(14) (defining "Federal consumer financial law" to include the "enumerated consumer laws," the provisions of title X of the Dodd-Frank Act, and the laws for which authorities are transferred under title X subtitles F and H of the Dodd-Frank Act); Dodd-Frank Act section 1002(12), 12 U.S.C. 5481(12) (defining "enumerated consumer laws" to include TILA); Dodd-Frank section 1400(b), 12 U.S.C. 5481(12) note (defining "enumerated consumer laws" to include certain subtitles and provisions of Dodd-Frank Act title XIV).

retaining the balloon-payment loans in portfolio, and meeting any asset size threshold, and any other criteria, the Bureau may establish.

*B. Other Rulemaking and Exception Authority*

This proposed rule also relies on other rulemaking and exception authorities specifically granted to the Bureau by TILA and the Dodd-Frank Act, including the authorities discussed below.

*Truth in Lending Act*

As amended by the Dodd-Frank Act, section 105(a) of TILA authorizes the Bureau to prescribe regulations to carry out the purposes of TILA. 15 U.S.C. 1604(a). Under section 105(a), such regulations may contain such additional requirements, classifications, differentiations, or other provisions, and may provide for such adjustments and exceptions for all or any class of transactions, as in the judgment of the Bureau are necessary or proper to effectuate the purposes of TILA, to prevent circumvention or evasion thereof, or to facilitate compliance therewith. A purpose of TILA is "to assure a meaningful disclosure of credit terms so that the consumer will be able to compare more readily the various credit terms available to him and avoid the uninformed use of credit." TILA section 102(a), 15 U.S.C. 1601(a). In particular, it is a purpose of TILA section 129C, as added by the Dodd-Frank Act, to assure that consumers are offered and receive residential mortgage loans on terms that reasonably reflect their ability to repay the loans and that are understandable and not unfair, deceptive, or abusive. 15 U.S.C. 1639b(a)(2).

Historically, TILA section 105(a) has served as a broad source of authority for rules that promote the informed use of credit through required disclosures and substantive regulation of certain practices. Dodd-Frank Act section 1100A clarified the Bureau's section 105(a) authority by amending that section to provide express authority to prescribe regulations that contain "additional requirements" that the Bureau finds are necessary or proper to effectuate the purposes of TILA, to prevent circumvention or evasion thereof, or to facilitate compliance therewith. This amendment clarified the Bureau's authority to exercise TILA section 105(a) to prescribe requirements beyond those specifically listed in the statute that meet the standards outlined in section 105(a), which include effectuating all of TILA's purposes. Therefore, the Bureau believes that its authority under TILA section 105(a) to make exceptions, adjustments, and additional provisions that the Bureau finds are necessary or proper to effectuate the purposes of TILA applies with respect to the purpose of section 129D. That purpose is to ensure that consumers understand and appreciate the full cost of homeownership. The purpose of TILA section 129D is also informed by the findings articulated in section 129B(a) that economic stabilization would be enhanced by the protection, limitation, and regulation of the terms of residential mortgage credit and the practices related to such credit, while ensuring that responsible and affordable mortgage credit remains available to consumers. *See* 15 U.S.C. 1639b(a).

TILA section 129C(b)(3)(B)(i) provides the Bureau with authority to prescribe regulations that revise, add to, or subtract from the criteria that define a qualified mortgage upon a finding that such regulations: are necessary or proper to ensure that responsible, affordable mortgage credit remains available to consumers in a manner consistent with the purposes of the ability-to-repay requirements; are necessary and appropriate to effectuate the purposes of the ability-to-repay and residential mortgage loan origination requirements; prevent circumvention or evasion thereof; or facilitate compliance with TILA sections 129B and 129C. 15 U.S.C. 1639c(b)(3)(B)(i). In addition, TILA section 129C(b)(3)(A) requires the Bureau to prescribe regulations to carry out such purposes. 15 U.S.C. 1639c(b)(3)(A).

TILA section 105(a) grants the Bureau authority to make adjustments and exceptions to the requirements of TILA for all transactions subject to TILA, except with respect to the substantive provisions of TILA section 129 that apply to high-cost mortgages. With respect to the high-cost mortgage provisions of TILA section 129, TILA section 129(p), 15 U.S.C. 1639(p), as amended by the Dodd-Frank Act, grants the Bureau authority to create exemptions to the restrictions on high-cost mortgages and to expand the protections that apply to high-cost mortgages. Under TILA section 129(p)(1), the Bureau may exempt specific mortgage products or categories from any or all of the prohibitions specified in TILA section 129(c) through (i), if the Bureau finds that the exemption is in the interest of the borrowing public and will apply only to products that maintain and strengthen homeownership and equity protections. Among these referenced provisions of TILA is section 129(e), the prohibition on balloon payments for high-cost mortgages.

### *C. The Dodd-Frank Act*

Section 1022(b)(1) of the Dodd-Frank Act authorizes the Bureau to prescribe rules "as may be necessary or appropriate to enable the Bureau to administer and carry out the purposes and objectives of the Federal consumer financial laws, and to prevent evasions thereof." 12 U.S.C. 5512(b)(1). TILA and title X and certain enumerated subtitles and provisions of title XIV of the Dodd-Frank Act are Federal consumer financial laws. Accordingly, the Bureau is exercising its authority under Dodd-Frank Act section 1022(b) to propose rules that carry out the purposes and objectives of TILA, title X of the Dodd-Frank Act, and certain enumerated subtitles and provisions of title XIV of the Dodd-Frank Act, and to prevent evasion of those laws.

## IV. Proposed Effective Date

The Bureau proposes that all of the changes proposed in this notice take effect on January 1, 2016. Specifically, the Bureau's proposed amendments to § 1026.35(b)(2)(iii)(A), (B), (C), and (D) and its commentary, to § 1026.35(b)(2)(iv)(A), (B), and (C) and its commentary, to § 1026.43(e)(6), and to the commentary to §§ 1026.43(e)(5) and 1026.43(f)(1) and (f)(2), take effect for covered transactions consummated on or after January 1, 2016. The Bureau believes this proposed effective date provides a date that is consistent with the end of the calendar year determinations required to be made with regard to the applicability of the special provisions and exemptions that apply to small creditors under the Bureau's regulations, as would be amended by the Bureau's proposal, and would therefore facilitate compliance by creditors. The Bureau seeks comment on whether the proposed effective date is appropriate, or whether the Bureau should adopt an alternative effective date.

## V. Section-by-Section Analysis of the Proposed Rule

*Section 1026.35 Requirements for Higher-Priced Mortgage Loans*

*35(b) Escrow Accounts*

*35(b)(2) Exemptions*

*35(b)(2)(iii)*

Except as provided in § 1026.35(b)(2)(v), § 1026.35(b)(2)(iii) provides that an escrow account need not be established for a transaction if four conditions identified in § 1026.35(b)(2)(iii)(A) through (D) are satisfied at the time of consummation. The Bureau proposes to make amendments to all of these conditions, as discussed below. As discussed in more detail above, the Bureau's authority to make these revisions rests in TILA as amended by the Dodd-Frank Act, and the Bureau believes the revisions carry out the Dodd-Frank Act's intent to treat certain small creditors differently than larger creditors. These proposed changes affect the eligibility of creditors for exemption from the higher-priced mortgage loan escrow requirements in the Bureau's January 2013 Escrows Final Rule. Because the requirements of § 1026.35(b)(2)(iii) are cross-referenced in the Bureau's January 2013 ATR Final Rule and its 2013 HOEPA Final Rule, the proposed changes also affect eligibility for certain special provisions and exemptions provided in those rules. These special provisions and exemptions, in effect, facilitate the ability of certain small creditors that operate in rural and underserved areas, as well as certain small creditors that operate in areas that are neither rural nor underserved, to originate mortgage loans. As discussed in the section-by-section analysis of § 1026.35(b)(2)(iii)(B) below, the special provisions and exemptions consequently help provide better access to credit for consumers served by those small creditors.

*35(b)(2)(iii)(A)*

*Background—"Rural" or "Underserved" Designation*

The Dodd-Frank Act amendments to TILA set forth two special provisions for small creditors operating predominantly in "rural" or "underserved" areas, without defining those terms. TILA section 129D, as added and amended by Dodd-Frank Act sections 1461 and 1462 and implemented by § 1026.35(b), generally requires that creditors establish escrow accounts for higher-priced mortgage loans secured by a first lien on a consumer's principal dwelling, but the statute also authorizes the Bureau to exempt from this requirement a creditor that, among other criteria, "operates predominantly in rural or underserved areas." TILA section 129D(c)(1), 15 U.S.C. 1639d(c)(1). Similarly, the ability-to-repay provisions in Dodd-Frank Act section 1412 allow balloon-payment mortgages to be considered qualified mortgages if, among other criteria, the balloon-payment mortgages are originated and held in portfolio by certain creditors that operate predominantly in rural or underserved areas. TILA section 129C(b)(2)(E), 15 U.S.C. 1639c(b)(2)(E).

In the January 2013 Escrows Final Rule and the January 2013 ATR Final Rule, the Bureau implemented the section 1461 higher-priced mortgage loan escrows requirement and the section 1412 balloon-payment qualified mortgage provision through §§ 1026.35(b)(2)(iii) and 1026.43(f), respectively. In addition, as part of the 2013 HOEPA Final Rule, the Bureau adopted in § 1026.32(d)(1)(ii)(C) an exemption to the general prohibition of balloon payments for high-cost mortgages when those mortgages meet the criteria for balloon-payment qualified mortgages set forth in § 1026.43(f). The Bureau, the Board, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the National Credit Union Administration, and the Office of the Comptroller of the Currency also adopted an exemption from a requirement to obtain a second appraisal for certain higher-priced mortgage loans under the January 2013 Interagency Appraisals Final Rule for any credit transaction that finances a consumer's acquisition of property "[l]ocated in a rural county, as defined in 12 CFR 1026.35(b)(2)(iv)(A)." *See, e.g.*, § 1026.35(c)(4)(vii)(H).

Through the January 2013 Escrows Final Rule, the Bureau adopted § 1026.35(b)(2)(iv)(A) and (B) to define which counties are "rural" and "underserved" respectively for the purposes of the Bureau's rules discussed above. The January 2013 Escrows Final Rule also provided comment 35(b)(2)(iv)-1 to clarify the criteria for "rural" and "underserved" counties and provided that the Bureau will annually update on its public Web site a list of counties that meet the definitions of rural and underserved in § 1026.35(b)(2)(iv). 78 FR 4725, 4741 (Jan. 22, 2013). In advance of the rule's effective date, the Bureau amended

§ 1026.35(b)(2)(iv) and comment 35(b)(2)(iv)-1 to clarify further how to determine whether a county is rural or underserved for the purposes of these provisions.[13]

Since publication of the 2013 Title XIV Final Rules, the Bureau has received extensive feedback on the definitions of “rural” and “underserved” that it adopted for purposes of the 2013 Title XIV Final Rule provisions described above.  Many commenters criticized the Bureau for defining “rural” and “underserved” too narrowly and urged the Bureau to consider alternative definitions.  Commenters were particularly critical of the Bureau’s definition of “rural,” which they asserted excluded many communities that are considered rural under other legal or regulatory definitions or that are commonly viewed as rural because of their small size or isolated or agricultural characteristics.

In light of the feedback received, the Bureau added § 1026.43(e)(6) in the May 2013 ATR Final Rule to allow small creditors during the period from January 10, 2014, to January 10, 2016, to make balloon-payment qualified mortgages even if they do not operate predominantly in rural or underserved areas.[14]  Section 1026.43(e)(6) applies only to loans consummated on or before January 10, 2016, two years after the effective date of the January 2013 ATR Final Rule. The Bureau announced that it would reexamine the “rural” and “underserved” definitions during this period to determine whether further adjustments were appropriate.  The Bureau also indicated that it would explore how it can best facilitate the transition of small creditors that do not operate predominantly in rural or underserved areas from balloon-payment loans to

[13] May 2013 Escrows Final Rule.

[14] Section 1026.43(e)(6) requires that all of the same criteria be satisfied as the balloon-payment qualified mortgage definition in § 1026.43(f) except the requirement that the creditor extend more than 50 percent of its total first-lien covered transactions in counties that are “rural” or “underserved.”  78 FR 35430, 35489-90 (June 12, 2013).

adjustable-rate mortgages as Congress intended under the Dodd-Frank Act. 78 FR 35430, 35489 (June 12, 2013).

The Bureau subsequently proposed revisions to § 1026.32(d)(1)(ii)(C) to allow small creditors to carry over the flexibility provided by the May 2013 ATR Final Rule into the HOEPA balloon-loan provisions.[15] In the September 2013 Final Rule, the Bureau extended the exception to the general prohibition on balloon features for high-cost mortgages under § 1026.32(d)(1)(ii)(C) to allow small creditors, regardless of whether they operate predominantly in "rural" or "underserved" areas, to continue originating balloon high-cost mortgages if the loans meet the requirements for qualified mortgages under §§ 1026.43(e)(6) or 1026.43(f). 78 FR 60382, 60414 (Oct. 1, 2013).

During the definitional review period leading up to January 10, 2016, the Bureau also sought to minimize volatility in the exemption provided by § 1026.35(b)(2)(iii) to the general requirement that creditors establish an escrow account for first-lien higher-priced mortgage loans. The first year-to-year transition under the "rural" definition for purposes of this exemption coincided with the decennial redesignation of Urban Influence Codes (UIC) assigned to counties by the United States Department of Agriculture's Economic Research Service (USDA-ERS) following the 2010 census, which determine which counties are considered "rural" in a particular year under the Bureau's current definition. As a result, there was a potential that a significant number of otherwise eligible creditors during 2013 would lose their eligibility for the

[15] Amendments to the 2013 Mortgage Rules Under the Equal Credit Opportunity Act (Regulation B), Real Estate Settlement Procedures Act (Regulation X), and the Truth in Lending Act (Regulation Z), 78 FR 39902, 39903 (July 2, 2013).

escrow exemption for 2014 if an adjustment was not made to stabilize the exemption during the definitional review period.[16]

To reduce volatility in the escrow exemption as the definitions are being reevaluated, the Bureau revised § 1026.35(b)(2)(iii) and its commentary to allow creditors to meet the condition in § 1026.35(b)(2)(iii)(A) for a particular calendar year based on loans made in "rural" or "underserved" counties in any of the three preceding calendar years. In instituting this three-year lookback period, the Bureau noted that the revisions to § 1026.35(b)(2)(iii)(A) would loosely approximate the two-year extension of the balloon special provision for qualified mortgages under § 1026.43(e)(6) and the two-year extension of the HOEPA balloon exemption under revised § 1026.32(d)(1)(ii)(C). 78 FR 60382, 60415-16 (Oct. 1, 2013). To satisfy the first of the four conditions in § 1026.35(b)(2)(iii) for exemption from the escrow requirement, § 1026.35(b)(2)(iii)(A) thus currently requires that during any of the three preceding calendar years, the creditor extended more than 50 percent of its total first-lien covered transactions, as defined by § 1026.43(b)(1),[17] on properties that are located in counties that are either "rural" or "underserved," as set forth in paragraph (b)(2)(iv) of the section (the "more than 50 percent" test).

*Bureau Proposal*

[16] Because of updated information from the 2010 Census, numerous counties' status under the Bureau's definition changed between 2013 and 2014, with a small number of new counties meeting the definition of "rural" and approximately 82 counties no longer meeting that definition. In proposing revisions to § 1026.35(b) and its commentary, the Bureau estimated that approximately 200-300 otherwise eligible creditors during 2013 might lose their eligibility for 2014 solely because of changes in the status of the counties in which they operate (assuming the geographical distribution of their mortgage originations did not change significantly over the relevant period). Setpember 2013 Final Rule, 78 FR 60382 at 60415-16.

[17] "Covered transaction" is defined in § 1026.43(b)(1) to mean a consumer credit transaction that is secured by a dwelling, as defined in § 1026.2(a)(19), including any real property attached to a dwelling, other than a transaction exempt from coverage under § 1026.43(a).

In advance of the sunset date for § 1026.43(e)(6), the Bureau proposes to amend § 1026.35(b)(2)(iii)(A) and comment 35(b)(2)(iii)-1 to adjust the time period used in assessing whether the rural or underserved test is met. The Bureau proposes to eliminate the three-year lookback period in § 1026.35(b)(2)(iii)(A) and to establish the preceding calendar year as the relevant time period for assessing whether the "more than 50 percent" test is satisfied as a general matter. The Bureau's proposal also creates a grace period to allow otherwise eligible creditors whose first-lien covered transactions in the preceding year failed to meet the "more than 50 percent" test to continue to operate with the benefit of the exemption with respect to applications received before April 1 of the current calendar year if their first-lien covered transactions during the next-to-last calendar year met the test.

Proposed § 1026.35(b)(2)(iii)(A) also substitutes the word "areas" for "counties" to conform to proposed changes to the "rural" definition in § 1026.35(b)(2)(iv)(A) that are discussed below.

As explained above, the Bureau adopted the three-year lookback period in § 1026.35(b)(2)(iii)(A) to minimize any negative impact on creditors from volatility in the "rural" and "underserved" definitions during the period in which the Bureau is reconsidering the definitions. As originally adopted in the January 2013 Escrows Final Rule, § 1026.35(b)(2)(iii)(A) considered only the preceding year. The Bureau instituted the three-year lookback period to stabilize the escrow exemption during the period from 2013 to 2015 while the definitions were under review. 78 FR 60382, 60416 (Oct. 1, 2013). This change guaranteed eligibility (for a creditor that was eligible during 2013 with respect to operating predominantly in rural or underserved areas, and met the other applicable criteria) through 2015. Stability in this specific period was a particular concern because during the definitional review the first year-to-year transition in the "rural" definition for purposes of this exemption was to coincide with the shift in USDA-ERS county UIC designations that occur once every decade.

Once the definitional review period ends, the Bureau does not believe that it would advance the overall purposes of the special provisions and exemptions to allow creditors to continue utilizing them for up to three years after their activity stops meeting the applicable test. Using a three-year lookback period on a permanent basis would allow creditors to maintain eligibility even if their first-lien covered transactions do not meet the "more than 50 percent" test in most calendar years, which seems contrary to the goal of identifying creditors that focus their activity in rural or underserved areas.

Although the three-year lookback period allows creditors to anticipate whether they will be eligible for the exemption at least two years into the future, the Bureau does not believe that such extended notice will be necessary once the proposed revisions to the definitions are finalized. As explained in the section-by-section analysis of proposed § 1026.35(b)(2)(iv)(A) below, the areas that are rural under the proposed definition would only change once or twice a decade.[18] While the counties defined as underserved could change each year, such shifts are unlikely to affect many creditors' eligibility for the special provisions and exemptions because there are very few counties that would be underserved but not rural under the Bureau's proposed definitions. The Bureau therefore believes that creditors that meet the "more than 50 percent"

[18] As noted in the discussion of comment 35(b)(2)(iv)-2 below, the Census Bureau released its list of urban areas based on the 2010 decennial census in 2012, and the USDA-ERS released its UIC designations based on the 2010 decennial census in 2013. If the USDA-ERS continues to incorporate decennial census results into its UIC county designations in a different year than the Census Bureau finalizes its rural-urban classification, as in 2012 and 2013, the effects of each decennial census would be incorporated into the Bureau's proposed "rural" definition over the course of two years, which would afford additional transition time to some of the creditors affected by the changes.

test in a typical calendar year are unlikely to fail to meet the test in the next calendar year unless their geographic service area and offerings change substantially.

Furthermore, creditors can monitor the first-lien covered transactions that they originate throughout the year and should generally be able to anticipate any change in their eligibility well before the end of the year. Any changes that would be made in the rural definition after each decennial census is completed would be based on demographic shifts that have unfolded over the preceding decade (which may, in many instances, be evident to creditors serving those areas) and would be announced well before they become effective, allowing time for creditors to assess their status and make appropriate transitions. Once the definitional review is completed, the Bureau therefore believes that the preceding calendar year will be the appropriate time period to utilize as a general rule in assessing whether the "more than 50 percent" test is met.

Notwithstanding these considerations, a creditor could find out on or close to December 31st that it was not operating predominantly in rural or underserved areas during that calendar year. Such a creditor might have difficulty transitioning from balloon-payment loans to adjustable-rate mortgages and complying with the higher-priced mortgage loan escrow requirements by January 1 if eligibility for the special provisions and exemptions is based solely on transactions in the preceding calendar year. The Bureau therefore proposes a grace period that allows a creditor making a higher-priced mortgage loan based on an application received before April 1 to rely on its transactions from either the preceding calendar year or the next-to-last calendar year to meet the condition in § 1026.35(b)(2)(iii)(A).

Under the proposal, a creditor that is otherwise eligible and that met the "more than 50 percent" test in calendar year one but fails to meet it in calendar year two remains eligible with respect to applications received before April 1 of calendar year three. The Bureau believes that a short grace period of this nature would facilitate the transition of creditors that no longer operate predominantly in rural or underserved areas and would properly balance the importance of the substantive consumer protections provided by the higher-priced mortgage loan escrows requirement, the ability-to-repay requirement, and HOEPA (for high-cost mortgages) with concerns that have been raised regarding their potential impact on access to credit.

The Bureau also proposes conforming and technical changes to the rule and commentary. Because the Bureau proposes to revise the “rural” definition in § 1026.35(b)(2)(iv)(A) to encompass certain areas that are not counties, the Bureau also proposes to substitute the word “areas” for “counties” in § 1026.35(b)(2)(iii)(A) where it appears.

Proposed comment 35(b)(2)(iii)-1.i incorporates changes that align with the changes that the Bureau proposes to the regulation text in §§ 1026.35(b)(2)(iii)(A) and 1026.35(b)(2)(iv)(A). The Bureau also proposes to remove from comment 35(b)(2)(iii)-1.i all discussion of the lists that the Bureau publishes of “rural” or “underserved” counties pursuant to § 1026.35(b)(2)(iv), in order to centralize updated commentary regarding such lists in proposed comment 35(b)(2)(iv)-1.iii.

The Bureau proposes a new comment 35(b)(2)(iii)-1.i.A that explains the relevant time period to use in assessing whether the “more than 50 percent” test in proposed § 1026.35(b)(2)(iii)(A) is met. As the proposed comment explains, whether this condition is satisfied generally depends on the creditor’s activity during the preceding calendar year. However, if the application for the loan in question was received before April 1, the creditor may instead meet this condition based on its activity during the next-to-last calendar year.

Proposed comment 35(b)(2)(iii)-1.i.B explains further how the test works. It states that a creditor meets the “more than 50 percent” test for any higher-priced mortgage loan consummated during the calendar year if a majority of its first-lien covered transactions in the preceding calendar year are secured by properties located in rural or underserved areas. The proposed comment further explains that, if the creditor's transactions in the preceding calendar year do not meet the "more than 50 percent" test, the creditor meets this condition for a higher-priced mortgage loan that is consummated during the current calendar year only if the application for the loan was received before April 1 and a majority of the creditor's first-lien covered transactions during the next-to-last calendar year are secured by properties located in rural or underserved areas. Proposed comment 35(b)(2)(iii)-1.i.B also provides illustrative examples to replace the example that currently appears in comment 35(b)(2)(iii)-1.i.

The Bureau invites comment on whether it should eliminate the three-year lookback period as proposed and whether it is appropriate to rely on the preceding calendar year in determining as a general matter whether the "more than 50 percent" test is met. The Bureau also seeks feedback on whether it should provide a grace period to creditors that meet this test in one calendar year but fail to do so in the next calendar year and, if so, whether such a grace period should apply to all applications received before April 1 as proposed.

*35(b)(2)(iii)(B)*

The Bureau proposes to revise the loan origination limit in § 1026.35(b)(2)(iii)(B). Section 1026.35(b)(2)(iii)(B) limits eligibility for the special provisions and exemptions to creditors that, together with their affiliates, in the preceding calendar year originated 500 or fewer covered transactions, as defined by § 1026.43(b)(1), secured by a first lien (origination limit). Section 1026.35(b)(2)(iii)(C) also requires such creditors to have less than $2 billion in assets (or other current yearly adjusted limit) at the end of the preceding calendar year (asset limit). The Bureau proposes to raise the origination limit from 500 loans to 2,000 loans, and to apply the limit only to loans not held in portfolio by the creditor or its affiliates. That is, under the proposal, the origination limit only applies to loans that were sold, assigned, or otherwise transferred by the creditor or its affiliates to another person, or subject at the time of consummation to a commitment to be acquired by another person. The Bureau’s proposal also adds a “grace period” from calendar year to calendar year to allow an otherwise eligible creditor that exceeded the origination limit in the preceding calendar year to continue to operate as a small creditor with respect to applications received before April 1 of the current calendar year—with the benefit of the special provisions and exemptions—as if it had not exceeded the origination limit in the preceding year.

*Background*

The special provisions and exemptions for small creditors included in the 2013 Title XIV Final Rules and related amendments (discussed in more detail below) are principally based on TILA sections 129D(c) and 129C(b)(2)(E), as adopted by sections 1461 and 1412, respectively, of the Dodd-Frank Act. TILA section 129D(c) authorizes the Bureau to exempt a creditor from the requirement (in section 129D(a)) that escrow accounts be established for higher-priced mortgage loans if the creditor operates predominantly in rural or underserved areas, retains its mortgage loans in portfolio, does not exceed (together with its affiliates) a total annual mortgage loan origination limit set by the Bureau, and meets any asset size threshold, and any other criteria the Bureau may establish, consistent with the purposes of TILA. TILA section 129C(b)(2)(E) permits certain balloon-payment mortgages to receive qualified mortgage status if they are originated by small creditors that, among other things, operate predominantly in rural or underserved areas, even though qualified mortgages are otherwise prohibited from having balloon-payment features.

The creditor qualifications under TILA section 129C(b)(2)(E) essentially mirror the criteria for the higher-priced mortgage loan escrow exemption, including (together with all affiliates) not exceeding a total annual mortgage loan origination limit set by the Bureau, retaining the balloon-payment loans in portfolio, meeting any asset size threshold, and any other criteria, the Bureau may establish, consistent with the purposes of TILA.

Both of these statutory provisions therefore provide that in order for a creditor to qualify as a "small creditor" for the exemptions from and special provisions related to the respective escrow and qualified mortgage requirements the following criteria must be met: (1) together with all affiliates, does not exceed a total annual loan origination limit to be set by the Bureau; (2) a requirement that the originated loans be retained in portfolio (for TILA section 129C(b)(2)(E) this requirement applies only to the creditor's originated balloon loans); and (3) any asset size threshold that the Bureau may establish. The statute requires the Bureau to set an annual loan origination limit—but provides the Bureau with some flexibility in establishing that limit. The statute authorizes, but does not require, the Bureau to establish an asset size threshold. The Bureau has established an asset limit to determine small-creditor status.

*Board Proposal*

Prior to the transfer by the Dodd-Frank Act of rulemaking authority for these statutory provisions to the Bureau, the Board issued proposals implementing TILA sections 129D(c) and 129C(b)(2)(E). With regard to 129D(c), providing the exemption from the higher-priced mortgage loan escrow requirements, the Board proposed to limit the exemption to creditors that (1) during either of the preceding two calendar years, together with affiliates, originated and retained servicing rights to 100 or fewer loans secured by a first lien on real property or a dwelling; and (2) together with affiliates, do not maintain escrow accounts for loans secured by real property or a dwelling that the creditor or its affiliates currently service.[19] In issuing this proposal, the Board stated that it sought to limit the exemption to creditors that maintain servicing portfolios too small to escrow cost effectively. The Board estimated that a minimum servicing portfolio size of 500 is necessary to escrow cost-effectively and assumed that the average life expectancy of a mortgage loan is approximately five years. The Board believed therefore that creditors would no longer need the benefit of the exemption if they originated and serviced more than 100 first-lien transactions per year. The Board proposed a two-year lookback period—providing that the test would be satisfied as long as the creditor's (and its affiliates') servicing-retained originations did not exceed 100 during either of the preceding two calendar years. The Board did not propose an asset-size threshold to qualify for the escrow exemption but sought comment on whether such a threshold should be established and, if so, what it should be.

The Board, with regard to the balloon-payment qualified mortgage definition to implement TILA section 129C(b)(2)(E), proposed two alternative annual origination limits and an asset-size limit of $2 billion.[20] The Board interpreted the qualified mortgage provision as designed to facilitate access to credit in areas where consumers may be able to obtain credit only from community banks offering balloon-payment mortgages. Under alternative 1, the creditor, together with all affiliates, extended covered transactions of some dollar amount or less during the preceding calendar year; under alternative 2, the creditor, together with all affiliates, extended some number of covered transactions or fewer during the preceding calendar year. The Board did not propose a specific annual origination limit in connection with TILA section

[19] 76 FR 11597 (Mar. 2, 2011) (2011 Escrows Proposal). The proposed exemption also would have required that, during the preceding calendar year, the creditor extended more than 50 percent of its total first-lien higher-priced mortgage loans in counties designated as rural or underserved, among other requirements.
[20] 76 FR 27390 (May 11, 2011).

129C(b)(2)(E), but the Board sought comment on the issue—for example, whether the threshold should be 100 loans per year or something greater or something less, or whether the threshold should be $100 million in aggregate covered-transaction loan amounts per year, or something greater or something less.

*Bureau Rulemaking*

Prior to the Board finalizing the above-described proposals, rulemaking authority to implement these sections of TILA passed to the Bureau in July 2011. The Bureau considered the Board's proposals and public comment before finalizing those rules,[21] as part of its rulemakings implementing title XIV of the Dodd-Frank Act, in January 2013.[22] In coming to a determination on the appropriate small creditor thresholds, the Bureau stated its belief that TILA section 129D(c)(2) reflects a recognition that larger creditors have the systems capability and operational scale to establish cost-efficient escrow accounts.[23] In addition, the Bureau stated its belief that TILA section 129C(b)(2)(E)(iv)(II) reflects a recognition that larger creditors that operate in rural or underserved areas should be able to make credit available without resorting to balloon-payment mortgages.[24]

The Bureau, after further analysis to determine the appropriate thresholds, adopted an annual origination limit of 500 first-lien covered transactions in the preceding calendar year and an asset-size limit of $2 billion, adjusted annually for inflation (§ 1026.35(b)(2)(iii)(B) and (C)).

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[21] The Bureau also conducted further analysis to try to determine the most appropriate thresholds, although it was significantly constrained by data limitations with regard to mortgage originations in rural areas generally and in particular with regard to originations of balloon-payment mortgages. *See* January 2013 ATR Final Rule, 78 FR 6407, 6545.

[22] January 2013 Escrows Final Rule; January 2013 ATR Final Rule; 2013 HOEPA Final Rule.

[23] 78 FR 4726, 4737 (Jan. 22, 2013).

[24] *Id.*

Specifically, the origination limit in § 1026.35 (b)(2)(iii)(B) provides that, during the preceding calendar year, creditors, together with their affiliates, must have originated 500 or fewer covered transactions, as defined by § 1026.43(b)(1), secured by a first lien. The asset limit in § 1026.35(b)(2)(iii)(C) requires creditors to have had less than $2 billion in assets (or other current yearly adjusted threshold) at the end of the preceding calendar year.

The Bureau believed that it would be preferable to use the same annual originations and asset-size limits for the qualified mortgage and escrow provisions to reflect the consistent statutory language, to facilitate compliance by not requiring institutions to track multiple metrics, and to promote consistent application of the two exemptions.[25] The Bureau noted that both provisions are focused in a broad sense on accommodating creditors whose systems constraints might otherwise cause them to exit the market.[26]

The Bureau adopted a threshold of 500 or fewer annual originations of first-lien transactions to provide greater flexibility and reduce concerns that the threshold in the Board's 2011 Escrows Proposal would reduce access to credit by excluding creditors that need special accommodations in light of their capacity constraints.[27] The Bureau believed that an origination

[25] *Id.*
[26] *Id.*
[27] The preamble to the January 2013 Escrows Final Rule noted that the increased threshold was not as limiting as it might first appear because the Bureau's analysis of HMDA data suggested that even small creditors are likely to sell a significant number of their originations in the secondary market, and, assuming that most mortgage transactions that are retained in portfolio are also serviced in-house, the Bureau estimated that a creditor originating no more than 500 first-lien transactions per year would maintain and service a portfolio of about 670 mortgage obligations over time (assuming an average obligation life expectancy of five years). Thus, the Bureau believed the higher threshold in the January 2013 Escrows Final Rule would help to ensure that creditors that are subject to the escrow requirement would in fact maintain portfolios of sufficient size to maintain the escrow accounts on a cost-efficient basis over time, in the event that the Board's 500-loan estimate of a minimum cost-effective servicing portfolio size was too low. At the same time, however, the Bureau believed that the 500 annual origination threshold in combination with the other requirements would still ensure that the balloon-payment qualified mortgage special provisions and escrow exemptions are available only to small creditors that focus primarily on a relationship lending model and face significant systems constraints. *Id.*

limit was the most accurate means of confining the special provisions to the class of small creditors with a business model the Bureau believed would best facilitate consumers' access to responsible, affordable credit, *i.e.*, creditors that focus primarily on a relationship-lending model. The Bureau also believed that an asset limit is important to preclude a very large creditor with relatively modest mortgage operations from taking advantage of a provision designed for much smaller creditors with much different characteristics and incentives that lack the scale to make compliance less burdensome.

Based on publicly available Home Mortgage Disclosure Act (HMDA) and Call Report data, the Bureau estimated that the small creditor provisions as finalized would include approximately 95 percent of creditors with less than $500 million in assets, approximately 74 percent of creditors with assets between $500 million and $1 billion, and approximately 50 percent of creditors with assets between $1 billion and $2 billion. The Bureau believed these percentages were consistent with the rationale for providing special accommodation for small creditors and would be appropriate to ensure that consumers have access to responsible, affordable mortgage credit.[28]

The Bureau also provided small creditor special provisions and exemptions, using the limits established in § 1026.35(b)(2)(iii)(B) and (C), beyond the small creditor exemption from the requirement for the establishment of escrow accounts for first-lien higher-priced mortgage loans, and the special provision permitting certain balloon-payment mortgages to receive

[28] In a later rulemaking, extending the same 500 first-lien origination threshold (as well as the $ 2 billion asset threshold) to a new category of qualified mortgages originated by small creditors (§ 1026.43(e)(5)) the Bureau stated in support of the threshold it was adopting that as the size of an institution increases it is expected that the scale of its lending business will increase as well. In addition, the Bureau noted that as the scale of a creditor's lending business increases, the likelihood that the institution is engaged in relationship-based lending and employing qualitative or local knowledge in its underwriting decreases. May 2013 ATR Final Rule, 78 FR 35429, 35486.

qualified mortgage status if originated by small creditors operating predominantly in rural or underserved areas. The Bureau extended these limits to create a small creditor exemption from the balloon-payment prohibition for high-cost loans, and to create a special qualified mortgage definition for portfolio loans made by small creditors.

Specifically, the special provisions and exemptions provided under the Bureau's 2013 Title XIV Final Rules—available only to small creditors—include the following:

- A qualified mortgage definition for certain loans made and held in portfolio (small creditor portfolio loans), which are not subject to the 43 percent debt-to-income ratio limit that applies to general qualified mortgage loans under § 1026.43(e)(2)) (§ 1026.43(e)(5)). A first-lien qualified mortgage under this category also provides a safe harbor from ability-to-repay claims, if the mortgage's annual percentage rate (APR) does not exceed the applicable Average Prime Offer Rate (APOR) by 3.5 or more percentage points. In contrast, general qualified mortgage loans under § 1026.43(e)(2) provide safe harbors if their APRs do not exceed the applicable APOR by 1.5 or more percentage points.[29]
- Two qualified mortgage definitions (*i.e.*, a permanent and a temporary definition) for certain loans made and held in portfolio that have balloon-payment features—an exception from the limitation on balloon-payment features on general qualified mortgage

[29] Specifically, for purposes of determining whether a loan has a safe harbor with regard to TILA's ability-to-repay requirements (or instead is categorized as "higher-priced" with only a rebuttable presumption of compliance with those requirements), for first-lien covered transactions, the special qualified mortgage definitions in § 1026.43(e)(5), (e)(6) and (f) receive an APR threshold of the applicable APOR plus 3.5 percentage points, rather than plus 1.5 percentage points.

loans (§ 1026.43(e)(6) and (f)).[30] As with the category of first-lien qualified mortgages discussed above (*i.e.*, small creditor portfolio loans defined in § 1026.43(e)(5)) these qualified mortgages are also subject to a higher APR threshold for defining a higher-priced covered transaction, allowing small creditors of such qualified mortgages to receive a safe harbor under the Bureau's ability-to-repay rule.

- An exception from the prohibition on balloon-payment features for certain high-cost mortgages (§ 1026.32(d)(1)(ii)(C))—also on a permanent and temporary basis.[31]
- An exception from the requirement to establish escrow accounts for certain higher-priced mortgage loans for small creditors that operate predominantly in rural or underserved areas (§ 1026.35(b)(2)(iii)).

The Bureau's special provisions for and exemption of small creditors from certain requirements of the 2013 Title XIV Final Rules are consistent with the different treatment accorded under the Dodd-Frank Act to small creditors versus larger creditors and were a recognition by the Bureau of the important role that small creditors play in providing mortgage credit to consumers. It was the Bureau's belief that small creditors' size and relationship lending model often provide them with better ability than large institutions to assess ability to repay. The

[30] Specifically these provisions allow: (1) on a permanent basis, balloon-payment qualified mortgage loans made and held in portfolio by certain small creditors operating predominantly in rural or underserved areas; and (2) for a temporary two year transition period—from January 10, 2014 to January 10, 2016—balloon-payment qualified mortgages originated by small creditors even if they do not operate predominantly in rural or underserved areas. To meet the "operating predominantly" in "rural" or "underserved" areas requirement, during any of the preceding three calendar years the creditor must have extended more than 50 percent of its total covered transactions, as defined by § 1026.43(b)(1), and secured by a first lien, on properties that are located in counties that are either "rural" or "underserved," as defined by § 1026.35(b)(2)(iv). *See* § 1026.35(b)(2)(iii)(A), the further section-by-section analysis of this requirement, and the Bureau's proposal to modify this provision.

[31] Specifically, this provision allows: (1) on a permanent basis, small creditors that operate predominantly in rural or underserved areas to originate high-cost loans with balloon-payment features; and (2) for loans made on or before January 10, 2016, small creditors to originate high-cost mortgages with balloon-payment features even if they do not operate predominantly in rural or underserved areas, under certain conditions. *See* § 1026.32(d)(1)(ii)(C).

Bureau recognized that many small creditors use a lending model based on maintaining ongoing relationships with their customers—and therefore may have a more comprehensive understanding of the financial circumstances of their customers. And since the lending activities of small creditors are often limited to a single community, they may have an in-depth understanding of the economic and other circumstances of that community.[32] The Bureau's special provisions and exemptions were also a recognition that small creditors lack economies of scale necessary to offset the cost of certain regulatory requirements—unlike larger creditors.[33]

Prior to and after the effective dates of the 2013 Title XIV Final Rules, the Bureau heard repeated expressions of concern that the Bureau's definition of small creditor was under-inclusive and did not cover a significant number of institutions that met the rationale underlying the special provisions and exemptions. Accordingly, on May 6, 2014, in a Notice of Proposed Rulemaking with proposals addressing other elements of the 2013 Title XIV Final Rules, the Bureau also sought comment on the 500 total first-lien origination limit—and the requirement that the limit be determined for any given calendar year based upon results during the immediately prior calendar year.[34] Specifically, the Bureau solicited feedback and data from (1) creditors designated as small creditors under the Bureau's 2013 Title XIV Final Rules; and (2) creditors with less than $2 billion in assets but that were not small creditors under the Bureau's 2013 Title XIV Final Rules because their total annual first-lien mortgage originations exceeded

[32] Lending activities of many creditors that currently qualify as small are generally limited to a single community. However, creditors that would qualify as small if the proposed provisions are adopted generally lend and have branches (in the case of depository institutions) in several communities and counties.

[33] However, the Bureau notes that, from the perspective of consumers, potential lack of economies of scale matters only to the extent that it affects access to credit.

[34] Amendments to the 2013 Mortgage Rules Under the Truth in Lending Act (Regulation Z), 79 FR 25730 (May 6, 2014).

the 500-loan limit. For such creditors, the Bureau requested data on the number and type of mortgage products offered and originated to be held in portfolio during the years prior to the effective date of the 2013 Title XIV Final Rules and subsequent to that date. The Bureau was particularly interested in how such creditors' origination mix changed in light of the Bureau's 2013 Title XIV Final Rules (including, but not limited to, the percentage of loans that had fixed rates, adjustable rates, or balloon-payment features), both as to loans originated for the secondary market and for portfolio.

The Bureau also solicited feedback on the implementation efforts of such small creditors with respect to the Bureau's 2013 Title XIV Final Rules. The Bureau was interested in the challenges that creditors might face when transitioning from originating balloon-payment loans to originating adjustable-rate loans. Finally, the Bureau solicited comment on whether the 500 total first-lien origination limit is sufficient to serve the purposes of the small creditor designation and, to the extent it may be insufficient, the reasons why it is insufficient and the range of appropriate limits.

*Comments Received*

In response to the Bureau's solicitation of comments in its May 6, 2014 proposal regarding the origination limit, industry commenters, including national and state bank trade associations, and national and state credit union associations, generally supported an increase in the 500 loan origination limit. Consumer groups generally did not support an increase, absent clear evidence that the current limit was significantly harming consumers. These commenters asserted that evidence of consumer harm does not exist.

Specifically, one major bank trade association for example suggested a $10 billion asset limit and a 2,000 per year loan origination limit. It stated that it believed that the 500 annual loan origination limit unnecessarily restricts credit to qualified borrowers. It stated that lenders, especially smaller lenders, faced with this limitation on gaining qualified mortgage status will make fewer loans than they otherwise would have, particularly for lower loan amounts, making it more difficult for rural and underserved borrowers—particularly those who are seeking smaller loans ($40,000 or less), which are generally not purchased on the secondary market. This commenter also stated that while its numbers were the product of anecdotal reports, consultation with banks in the $500 to $750 million asset range revealed that 1,000 loan originations per year is a common amount at this asset size, and that the 500-loan limit is unnecessarily restricting.

One community banking association recommended that all community bank mortgage loans that are held in portfolio for the life of the loan receive qualified mortgage safe harbor status and exemption from escrow requirements if they are higher-priced mortgage loans. This commenter noted that a limit of 500 total first-lien originations per year is only 41 first-lien mortgages per month, or nine per week, an amount that a small creditor could easily exceed. It stated further that most community banks that exceed either or both the asset limit or origination limit have all the attributes of traditional, relationship-based community banks, and that it found that the origination limit, which it noted is extremely low for most community banks, is not consistent with the asset limit. The commenter urged the Bureau, at a minimum, to increase the origination limit to at least 2,000 first-lien mortgage loans, or to disregard loans sold into the secondary market when applying the annual loan limit.

Other industry commenters support increasing the origination limit to 1,000 loans per year—asserting, for example, that: (1) this would increase the number of small creditors covered by 10 percent; (2) a 1,000 loan threshold more appropriately matches the $2 billion asset limit, *i.e.*, entities with $2 billion in assets have at least 500 annual originations and a number originate more than 500 loans; and (3) a number of entities operate close to the 500 origination limit, and a 1,000 limit will provide smaller creditors with a cushion for fluctuation in mortgage volume, saving them the expense of preventative compliance measures in anticipation of exceeding the limit.

A residential mortgage industry consulting firm commenter asserted that a bank with under 500 originations per year and another bank with originations between 500 and 1,000—but still under $2 billion in assets—are both likely to be community banks with the virtues of an elevated level of service and personal attention to borrowers. Both banks, this commenter noted, are equally unable to spread the costs of compliance across an organization in the way a very large institution is able to do—another fact, this commenter asserted, that is a reason for the small creditor exception in the first place.

Some industry commenters in advocating for a higher loan origination limit argued that the Bureau's reliance on HMDA data for the 500 origination limit was flawed. For example, one state bankers association noted that the Bureau stated that, based on HMDA data, the small creditor definition would include: 95 percent of creditors with less than $500 million in assets; 74 percent of creditors with assets between $500 million and $1 billion; and 50 percent of creditors with assets between $1 billion and $2 billion. It then stated that it polled its member banks and did not find this to be true in its state and reminded the Bureau, because of that state's limited number of metropolitan statistical areas (MSAs) and rural nature, many creditors are not HMDA reporters. It concluded that basing small-creditor status on HMDA origination numbers is flawed when attempting to analyze rural lending patterns.

Another state bankers association (in advocating for an increase of the origination limit to 1500 loans) noted that the Bureau has recognized that its adoption of annual origination limits and asset size limits were significantly constrained by data limitations. It stated further that, as the Bureau relied on its analysis of HMDA data to set the requirements for small-creditor status, data from institutions not subject to HMDA reporting (*i.e.*, institutions with less than $43 million in assets, under the calendar year 2014 asset size threshold for HMDA reporting) were not considered.

In addition to recommending increasing the origination limit, some commenters alternatively suggested that the origination limit either be applied to originated loans only if held in portfolio or that the limit exclude loans held in portfolio.

In the first category of these commenters, *i.e.*, those suggesting that the origination limit be applied to originated loans only if held in portfolio, one state credit union association stated that, due to the legal liability risk that surrounds non-qualified mortgages, some small credit unions (under $2 billion in assets) have made the business decision to offer only qualified mortgages. It stated that, of these small credit unions, a portion sell loans on the secondary market, which causes them to exceed the 500 total first-lien origination limit. If the loan does not meet the general definition of qualified mortgage, this commenter noted, it cannot be sold on the secondary market and the alternative definitions of qualified mortgage generally requires the credit union to keep the loan in portfolio for three years, unless an exception is met. It recommended therefore that the 500 loan origination limit is more properly placed on first-lien covered transactions originated in the preceding year kept in portfolio versus all first-lien covered transactions originated in the preceding year which would include those sold on the secondary market. Alternatively, this organization recommended that the 500 loan origination limit needs to be significantly increased for creditors that sell on the secondary market and also keep loans in portfolio.

Also in this first category of commenters (*i.e.*, those suggesting the origination limit only include portfolio loans) was a non-profit research and policy organization which commented that the 500-loan origination limit could be increased in narrow circumstances, such as increasing the loan origination limit for rural banks, or redefining the 500 limit to loans held in portfolio. And, as noted, a community banking association recommended that the Bureau, as an alternative to increasing the origination limit to 2,000 loans, disregard loans sold into the secondary market when applying the origination threshold number.

In the second category of commenters (*i.e.*, those suggesting that loans held in portfolio be excluded from the origination limit), a state bankers association strongly recommended that the Bureau expressly state that loans held in an institution's portfolio are not counted toward the origination limit for small-creditor status, in addition to recommending that the origination limit be raised to 1,500 loans in a calendar year. This commenter stated that expansion of the small creditor category would help avoid contraction of the availability of mortgage credit. It stated that many creditors that currently qualify as small creditors are given the incentive to limit their mortgage lending to remain within the small creditor category—due to the exemptions afforded to small creditors.

Among other industry recommendations for revising the loan origination limit was a recommendation by a state bankers association that the Bureau revise the provision in which the loan origination limit must include originations by all the creditor's affiliates, in addition to the creditor. This commenter suggested that the Bureau revise the definition so that the origination limit includes only originations by the creditor and its non-depository financial institution affiliates, such as finance companies, mortgage companies, and brokers. The organization stated that, in doing this, small creditors that are owned by the same bank holding company, but operate independently, will be more likely to continue to meet the lending needs of their communities and still enjoy creditor protections from regulatory and legal risk offered by the small creditor qualified mortgage safe harbor.

As noted, consumer group commenters generally did not support an increase in the 500-loan origination limit, at least without evidence of harm justifying an increase. Two consumer group commenters in their joint comment letter stated, for example, that creditors making 500 or more loans (and likely even fewer) should be able to comply with the Bureau's ability-to-repay/qualified mortgage requirements. They noted that 500 loans likely involve millions of dollars and this exception will already affect thousands of borrowers. Expanding this exception any further, they asserted, will substantially weaken the Bureau's ability-to-repay/qualified mortgage requirements and should not be done without an overwhelmingly clear and urgent justification. Such a justification does not currently exist, they stated. For that reason they recommended that the Bureau should leave the current limit unchanged. Another fair housing organization commenter mirrored the comment of these two organizations.

As noted, a non-profit research and policy organization stated that an increase in the origination limit might be justified but only with more data showing the current limit is creating problems for small creditors to conduct business and reach underserved markets. In addition the commenter urged the Bureau to continue to examine the appropriate models to determine if the 500 origination limit is in fact harming bona fide small creditors or serving as a barrier for small creditors to reach more credit worthy borrowers. It stated that any increase in the origination limit should be reasonable both to ensure that small creditors can continue to do business (in particular with underserved markets) and to ensure that larger entities will not have an opportunity to take undue advantage of a change in the rule. Unless there is substantial evidence, however, that the loan origination limit is too low, the commenter supported keeping the exception narrow and limited.

*Bureau Proposal*

As discussed, the Bureau proposes to revise the origination limit in § 1026.35(b)(2)(iii)(B). Specifically, the Bureau proposes to raise the origination limit from 500 covered transactions secured by a first-lien (or "loans") originated by the creditor and its affiliates to 2,000 such loans. The Bureau's proposal also makes the limit applicable only to loans not held in portfolio by the creditor or its affiliates. That is, under the proposal, the limit does not apply to loans that were not sold, assigned, or otherwise transferred by the creditor or its affiliates to another person, or subject to a commitment to be acquired by another person. The Bureau's proposal also adds a "grace period" from calendar year to calendar year to allow an otherwise eligible creditor that exceeded either the origination limit or the asset limit in the preceding calendar year to continue to operate as a small creditor with respect to applications received prior to April 1 of the current calendar year—with the benefit of the special provisions and exemptions—as if it had not exceeded the limits in the preceding year. This proposed grace period is available to creditors that exceeded the respective limits in the preceding calendar year but had not exceeded them in the calendar year prior to the preceding calendar year.

Proposed comment 35(b)(2)(iii)-1.ii explains that only originated loans not retained by the creditor or its affiliates in portfolio are counted toward the new 2,000 origination limit. The proposed comment also makes clear that a loan transferred by a creditor to its affiliate is a loan not retained in portfolio (it is a loan transferred to "another person") and therefore is counted toward the 2,000 origination limit. The proposed comment explains and adds examples on applying the grace period to the origination limit.

Given the comments received to date on the origination limit, the Bureau believes that an adjustment of the current origination limit, as proposed, is justified. Small creditors serve a particularly critical function for consumers in rural and underserved areas, especially when these creditors make portfolio loans for which there may be no secondary market. At the same time, the Bureau recognizes consumer groups' concerns that an expansion of the origination limit could undermine the Bureau's Dodd-Frank Act title XIV regulatory protections. Specifically, the Bureau also wants to ensure that the origination limit is not set at a level that will allow larger creditors to take advantage of small-creditor status to avoid important regulatory requirements that protect consumers—regulatory requirements that those larger creditors, unlike many smaller creditors, have the capacity to implement effectively.

Comments received from industry commenters are consistent and clear—the current origination limit, as currently constructed, may have the effect of limiting smaller creditors' ability to provide credit to qualified borrowers. According to commenters, the current origination limit does this by, for example, moving creditors to originate fewer loans than they otherwise would (including fewer loans for lower loan amounts that serve rural and underserved borrowers), to achieve or preserve small-creditor status. In addition, creditors that have the relationship lending models and community ties—the attributes of a creditor that the Bureau believes should be accorded small-creditor status—say that they simply have a volume of business that exceeds the current origination limit (even though they may meet the asset limit for small-creditor status).

Industry commenters consistently noted the mismatch between the origination limit and asset limit. They also stated that the origination limit was clearly the more problematic of the two limits for community banks, credit unions, and other relationship lenders. Industry commenters stated that the current origination limit is particularly difficult for those creditors that operate at the margins of the origination limit and small-creditor status. These creditors face concerns about the impact of origination volume fluctuations from year to year, which may move them from small-creditor status to non-small-creditor status on short-notice without sufficient time to modify systems and products to address such a change. This shifting status from year to year would force such creditors to incur an additional expense to plan for meeting the regulatory requirements otherwise faced by creditors without small-creditor status.

The issues cited by these commenters are clearly not the result the Bureau was seeking when it set the limits for according special status for small creditors. The Bureau's intent was not to exclude small creditors that could provide responsible, affordable credit to consumers, such as small community lenders, and thereby potentially limit the access of those consumers to creditors with a lending model, operations, and products that may meet their particular needs.

The Bureau believes its proposed origination limit addresses these issues in an effective and responsible way that is consistent with the intent of the Dodd-Frank Act in according small creditors different treatment with regard to certain requirements. Expanding the origination limit to 2,000 loan originations, and not including portfolio loans in that originations count, would increase the number of creditors that receive small-creditor status by 700 creditors, from approximately 9,700 to approximately 10,400 (as further discussed in the Section 1022(b) Analysis below). The Bureau believes that this increase would include creditors with responsible lending models and economies of scale that fit the purpose of small-creditor status.

In particular, the proposed exclusion from the origination limit count of loans held in portfolio by the creditor (and its affiliates) is a recognition that smaller institutions that originate loans to be funded out of their own assets and held in portfolio have different interests than creditors, including smaller institutions, that originate loans to sell them into the secondary market. The interests of smaller institutions making portfolio loans are more likely to be aligned with the interests of those consumers with whom they do business. The proposed exclusion of portfolio loans is also consistent with the rationale behind the additional requirements under the Bureau's rules for application of the small creditor special provisions to only those qualified mortgages that creditors retain in portfolio (*see, e.g.*, TILA section 129C(b)(2)(E) and § 1026.43(e)(5), (e)(6) and (f)). The rationale articulated by the Bureau in that instance applies here—that the discipline imposed when small creditors make loans that they will hold in their portfolios is important to protect the consumers' interest and to prevent evasion. In other words, the Bureau's proposal not to include portfolio loans in the origination limit count is based on a recognition not only of the small creditor's community-based focus and commitment to relationship lending, but also the inherent incentives associated with portfolio lending by smaller institutions.

The proposed grace period also addresses industry commenters' concerns regarding the impact of origination volume fluctuations from year to year. These commenters noted that small creditors on the margins of the origination limit could lose small-creditor status on short notice. The proposed grace period allows an otherwise eligible creditor that exceeded the origination limit in the preceding calendar year to continue to operate with respect to applications received before April 1 of the current calendar year with the benefit of the small creditor exemptions. Such a creditor could operate as if it had not exceeded the limits in the preceding year, as long as the creditor did not exceed the origination limit in the year prior to the preceding calendar year. This proposed grace period should provide the time for creditors to make any needed adjustments to change their systems to come into compliance with the Bureau's regulatory requirements.  It also helps alleviate additional preparation burdens creditors might otherwise confront in anticipation of not meeting the small creditor origination limit.

The Bureau's primary goal is to draw the appropriate line between small and large creditors, and to strike the right balance between preserving consumer access to credit, eliminating regulatory requirements that would hinder the ability of small creditors to provide that access to credit to potential borrowers, and maintaining effective consumer protections.  The Bureau therefore continues to seek comment on alternative methods of achieving the purposes underlying small-creditor status and, specifically, for setting the origination limit and alternatives to the proposed grace period.

*35(b)(2)(iii)(C)*

The Bureau proposes to amend § 1026.35(b)(2)(iii)(C) to include in the calculation of the $2 billion asset limit the assets of the creditor's affiliates that originate covered transactions secured by a first lien.  Proposed comment 35(b)(2)(iii)-1.iii provides that, for purposes of § 1026.35(b)(2)(iii)(C), in addition to the creditor's assets, only the assets of a creditor's "affiliate" as defined in § 1026.32(b)(5) that originates covered transactions (as defined by § 1026.43(b)(1)) secured by a first lien are counted toward the asset limit.  Thus, under the proposed rule, only assets of affiliates that engage in the type of mortgage lending covered by Regulation Z's ability-to-repay provisions are counted toward the asset limit.

Counting both the creditor's assets and the assets of the creditor's affiliates that originate mortgage loans would make the tests for determining small-creditor status consistent between the asset limit in § 1026.35(b)(2)(iii)(C) and the origination limit in § 1026.35(b)(2)(iii)(B), which currently includes the originations of the creditor's affiliates in determining whether the limit has been exceeded.  This additional consistency between the two tests may facilitate creditor compliance with the special provisions and exemptions for small creditors, including those that operate predominantly in rural or underserved areas, of which the two tests are a part. More significantly, the Bureau believes that this change follows logically from the other changes being proposed here.

As noted, only the assets of the creditor's affiliates that originate mortgage loans are counted toward the asset limit under the proposed rule. Given the proposed change to the origination limit to exclude the creditor's and its affiliate's portfolio loans from counting toward that limit, the Bureau believes the proposed change to the asset limit is necessary to ensure that small-creditor status does not become a means for larger creditors to evade important requirements that provide consumer protections.

As noted previously, although it was not required to do so, the Bureau established an asset limit because it believed that it is important to preclude a very large creditor with relatively modest mortgage operations from taking advantage of a provision designed for much smaller creditors with much different characteristics and incentives and that lack the scale to make compliance less burdensome. The Bureau wants to prevent a situation where creditors with substantially more than $2 billion in assets (but that did not exceed the proposed origination limit of 2,000 non-portfolio loans) could create affiliate relationships with a number of entities—all under the $2 billion asset limit—that could then originate an unlimited number of loans to be held in portfolio and maintain status as small creditors. Such a creditor is not the type of small entity that the Bureau intended to take advantage of the special provisions and exemptions provided to smaller creditors.

The Bureau is seeking comment on this proposed change to § 1026.35(b)(2)(iii)(C) (and the corresponding change to comment 35(b)(2)(iii)-1.iii) to include in the calculation of the $2 billion asset limit the assets of the creditor's affiliates that originate covered transactions secured by a first lien. In particular the Bureau is interested in comments on the potential impact of this change on creditors and access to credit, and the potential for larger creditors to obtain small-creditor status without this change and the possible impact on consumers. In addition, the Bureau seeks comment on its proposal to count only the assets of the creditor's affiliates that originate covered transactions secured by a first lien toward the origination limit—and not the assets of other affiliates of the creditor.

The Bureau also proposes to add a grace period to the $2 billion asset limit in § 1026.35(b)(2)(iii)(C). This proposed grace period allows an otherwise eligible creditor that exceeded the asset limit in the preceding calendar year to continue to operate as a small creditor with respect to applications received before April 1 of the current calendar year. Such a creditor could operate with the benefit of the small creditor special provisions and exemptions (assuming the origination limit and other applicable regulatory requirements are met) with respect to such applications. This proposed grace period is available to creditors that exceeded the asset limit in the preceding calendar year but had not exceeded it in the calendar year prior to the preceding calendar year.

Proposed comment 35(b)(2)(iii)-1.iii explains that creditors meet the asset limit for any higher-priced mortgage loan consummated during calendar year 2016 if the creditors' total assets (which include, in addition to the creditors' assets, the assets of the creditors' affiliates that originate mortgage loans) are under the applicable asset limit on December 31, 2015. The proposed comment explains further that creditors that did not satisfy the applicable asset limit on December 31, 2015 satisfy the asset limit criterion for a higher-priced mortgage loan consummated during 2016 if the application for the loan was received before April 1, 2016 and the creditors had total assets under the applicable asset limit on December 31, 2014. The proposed comment also adds to the 2013 calendar year asset limit currently listed in the comment the thresholds for calendar year 2014 and for calendar year 2015. In providing the threshold for calendar year 2015 ($2,060,000,000), the proposed comment explains that creditors that had total assets of less than $2,060,000,000 on December 31, 2014, satisfy this criterion for purposes of (1) any loan consummated during 2015 and (2) any loan consummated during 2016 for which the application was received before April 1, 2016.

The Bureau proposes the grace period to provide consistency in requirements for creditors seeking and maintaining small-creditor status. The Bureau is seeking comment, however, on the need for the grace period for the asset limit, in light of industry comments indicating that the origination limit was the main focus of concern regarding failure to meet small-creditor status and the impact of origination volume fluctuations causing failure to meet that limit with possible little advance notice.

*35(b)(2)(iii)(D)*

In general, § 1026.35(b)(2)(iii)(D) currently prohibits any creditor from availing itself of the exemption from escrow requirements in § 1026.35(b)(2)(iii) if the creditor maintains escrow accounts for any extension of consumer credit secured by real property or a dwelling that it or its affiliate currently services. However, § 1026.35(b)(2)(iii)(D) generally provides that a creditor may qualify for the exemption if such escrow accounts were established for first-lien higher-priced mortgage loans on or after April 1, 2010, and before January 1, 2014, or were established after consummation as an accommodation for distressed consumers.[35] In light of the proposed expansion of the "small" and "rural" definitions in §§ 1026.35(b)(2)(iii)(B) and 1026.35(b)(2)(iv)(A) discussed above and below, the Bureau proposes to substitute January 1, 2016 for January 1, 2014 where it appears in § 1026.35(b)(2)(iii)(D)(*1*) and its commentary. This proposed change prevents any creditors that are currently ineligible for the escrow exemption, but that would qualify if the proposed definitional changes are adopted, from losing eligibility for the escrow exemption because of escrow accounts they established for first-lien higher-priced mortgage loans pursuant to requirements in the current rule.

Creditors that do not currently meet the requirements in § 1026.35(b)(2)(iii)(A) through (D) are generally required under § 1026.35(b) to establish escrow accounts for any higher-priced mortgage loans those creditors make. However, if the expansions of the origination limit and rural definitions in proposed §§ 1026.35(b)(2)(iii)(B) and 1026.35(b)(2)(iv)(A) are finalized, it is possible that some creditors that currently are ineligible under § 1026.35(b)(2)(iii)(A) or (B) would meet the conditions in § 1026.35(b)(2)(iii)(A) and (B) after the changes take effect. Even if such creditors satisfy the condition set forth in § 1026.35(b)(2)(iii)(C), however, current § 1026.35(b)(2)(iii)(D) would generally deem them ineligible for exemption after the effective date if they maintain an escrow account that they were required to set up prior to the effective date.

If the proposed changes to § 1026.35(b)(2)(iii) and (iv) are finalized, the Bureau does not believe that such creditors should lose the exemption simply because they were required by

[35] Comment 35(b)(2)(iii)(D)(*1*)-1 clarifies that the date ranges provided in § 1026.35(b)(2)(iii)(D)(*1*) apply to transactions for which creditors received applications on or after April 1, 2010, and before January 1, 2014.

applicable regulations to establish escrow accounts prior to January 1, 2016. As the Bureau discussed in the Supplementary Information to the January 2013 Escrows Final Rule and again in finalizing amendments to the January 2013 Escrows Final Rule in the September 2013 Final Rule, the Bureau believes creditors should not be penalized for compliance with the current regulation.[36] The Bureau thus believes it is appropriate to amend § 1026.35(b)(2)(iii)(D)(*1*) and comment 35(b)(2)(iii)(D)(*1*)-1 to exclude escrow accounts established on or after April 1, 2010 and before January 1, 2016. This proposed change makes creditors eligible for the exemption provided under proposed § 1026.35(b)(2)(iii) if they otherwise meet the requirements of § 1026.35(b)(2)(iii) and they do not establish new escrow accounts for transactions for which they receive applications on or after January 1, 2016, other than those described in § 1026.35(b)(2)(iii)(D)(*2*).

To conform the commentary to this change, the Bureau also proposes to change January 1, 2014 to January 1, 2016 where it appears in comment 35(b)(2)(iii)(D)(*1*)-1. Proposed comment 35(b)(2)(iii)(D)(*1*)-1 thus clarifies that the date ranges provided in § 1026.35(b)(2)(iii)(D)(*1*) apply to transactions for which creditors received applications on or after April 1, 2010, and before January 1, 2016.

The Bureau solicits comment on the Bureau's proposed amendments to § 1026.35(b)(2)(iii)(D)(*1*) and comment 35(b)(2)(iii)(D)(*1*)-1, and specifically the exclusion of escrow accounts established on or after April 1, 2010 and before January 1, 2016 from the

[36] With respect to loans where escrows were established on or after April 1, 2010, and before June 1, 2013, the Supplementary Information to the January 2013 Escrows Final Rule explained that creditors should not be penalized for compliance with the then current regulation, which would have required any such loans to be escrowed after April 1, 2010, and prior to June 1, 2013—the date the exemption took effect. January 2013 Escrows Final Rule, 78 FR 4725, 4739; *see also* September 2013 Final Rule, 78 FR 60382, 60416.

limitation in § 1026.35(b)(2)(iii)(D). In particular, the Bureau seeks comment on the need for the proposed changes and the impact on consumers of extending the exemption to the escrow requirements in § 1026.35(b)(1).

*35(b)(2)(iv)(A)*

*"Rural"*

Section 1026.35(b)(2)(iv)(A) currently defines a county as "rural" during a calendar year if it is neither in an MSA nor in a micropolitan statistical area that is adjacent to an MSA, as those terms are defined by the U.S. Office of Management and Budget and as they are applied under currently applicable UICs, established by the USDA-ERS. It further provides that a creditor may rely as a safe harbor on the list of counties published by the Bureau to determine whether a county qualifies as "rural" for a particular calendar year. Comments 35(b)(2)(iv)-1 and -2 provide additional clarification about how to determine which counties fall within this definition and examples.

The Bureau proposes to expand the "rural" definition in § 1026.35(b)(2)(iv)(A) to capture additional areas classified as "rural" by the Census Bureau, without affecting the status of any counties that would be deemed rural under the Bureau's existing definition. For technical reasons, the Bureau also proposes to move the discussion of the safe harbor list of counties provided by the Bureau that is currently in § 1026.35(b)(2)(iv)(A) and comment 35(b)(2)(iv)(A)-1 to new § 1026.35(b)(2)(iv)(C) and proposed comment 35(b)(2)(iv)(A)-1.iii, which are discussed below.[37]

[37] This proposed move is consistent with a similar move that the Bureau proposes with respect to the safe harbor discussion that currently appears with the "underserved" definition in § 1026.35(b)(2)(iv)(B).

In response to the January 2013 ATR Proposal and to proposed amendments to the January 2013 Escrows Final Rule, the Bureau received a number of comments regarding how "rural" and "underserved" should be defined for purposes of the balloon-payment qualified mortgage provisions and the escrow exemption.  78 FR 30739, 30741 (May 23, 2013); 78 FR 35430, 35491 (June 12, 2013).  Commenters including national and State trade groups representing creditors and dozens of small creditors argued that the current definitions of rural and underserved are too restrictive and do not adequately preserve consumers' access to credit.

Some of these commenters proposed that the Bureau adopt alternate definitions of "rural," such as those used by the U.S. Department of Agriculture's Rural Housing Loan Program or the Farm Credit System.  One industry trade association suggested that the rural definition should include all non-metropolitan counties, as well as communities with populations of less than 50,000.  Another commenter suggested that any place not within one of the Census Bureau's "urbanized areas," which contain 50,000 or more people, should be considered rural.  A credit union association suggested that credit unions with "rural" community charters should be exempt.  It also objected to the current rule's provision that a county designated as a micropolitan statistical area is not "rural" if it is adjacent to an MSA.

Several commenters criticized the current definition's assumption that an entire county is either rural or non-rural.  These commenters noted that many counties are in fact made up of a mix of rural and non-rural areas.  One industry trade association commenter noted that by excluding entire counties the Bureau is excluding many rural communities where community banks provide much of the mortgage financing through loans they originate and retain in portfolio.  According to the commenter, many of these loans are balloon-payment loans, and many community banks do not escrow for taxes and insurance.

Many commenters cited examples of areas that they believe are truly rural but that are not classified as rural by the current regulation. Two trade association commenters noted, for example, that only 3 counties in Maryland qualified as rural, even though many of the remaining areas in Maryland are serviced by the Farm Credit System. Other commenters noted that less than a third of Louisiana parishes qualified as “rural,” even though by many measures Louisiana is a very rural state.

A number of commenters expressed concern that if the rural definition is not expanded, the number of new lenders entering markets that appear to be rural in nature but that fall outside of the definition will decrease. They indicated that some existing lenders will either exit these markets or curtail certain types of lending, leaving consumers in these areas with few choices. Commenters noted that the ability to originate mortgages with balloon payments is important to small creditors, who often have unique product pricing risks and also may not have adequate staff or training to produce the additional disclosures required by adjustable-rate mortgages.[38]

Since the Bureau announced that the definition was under review, it has received additional feedback on the rural definition outside of the formal comment process. For example, one industry trade association urged the Bureau to expand the rural definition if it did not make the special provisions and exemptions more broadly available in other ways. The association noted that the current definition of “rural” adopted by the January 2013 ATR Final Rule and the

[38] In its comments in 2013, one industry trade association reported that in a recent survey of approximately 400 members that are community banks, 75 percent indicated they currently make balloon-payment mortgages, and only 46 percent would be able to use the balloon mortgage exemption to the ability-to-repay rule. It also noted that, of the banks that responded to the survey that considered themselves to be rural or in a rural community, 44 percent did not meet the Bureau’s definition of rural.

January 2013 Escrows Final Rule covers only about 7 percent of the U.S. population, whereas the Census Bureau recognizes about 20 percent of the U.S. population as living in a rural area.

The Bureau believes that its current county-based approach facilitates application of the "rural" definition because it is easy to discern the county in which a property is located and to check whether that county appears on the lists published by the Bureau. However, the Bureau also appreciates the concern that has been raised by commenters that the current definition excludes from the definition certain areas that might otherwise be identified as rural, solely on the basis of the county in which the area is located. Many counties are large and may include both rural and urban areas, as commenters have noted.

The Bureau has considered a variety of possible approaches that could be used to identify areas that are smaller than counties that may be rural in nature. Of these, the Bureau believes that the urban-rural classification completed by the Census Bureau every ten years may be the most suitable for the Bureau's current purposes. This classification is done at the level of the census block, which is the smallest geographic area for which the Census Bureau collects and tabulates decennial census data. While there are only about 3,000 counties in the United States, there are approximately 11 million census blocks.[39] The Census Bureau delineates census blocks as "urban" or "rural" based on each decennial census and most recently released its list of urban areas based on the 2010 Census in 2012. For the 2010 Census, an urban area consists of "a densely settled core of census tracts and/or census blocks that meet minimum population density requirements, along with adjacent territory containing non-residential urban land uses as well as

[39] Census Bureau, *2010 Census Tallies of Census Tracts, Block Groups & Blocks*, https://www.census.gov/geo/maps-data/data/tallies/tractblock.html.

territory with low population density included to link outlying densely settled territory with the densely settled core."[40] The Census Bureau identifies two types of urban areas: "urbanized areas" of 50,000 or more people, and "urban clusters" of at least 2,500 and less than 50,000 people. Under the Census Bureau's classification, "rural" encompasses all population, housing, and territory not included within either type of urban area.

The Bureau proposes to ensure that areas with rural characteristics that are located in counties with both rural and urban characteristics are included within the Bureau's definition. The proposal adds a second prong to the definition in § 1026.35(b)(2)(iv)(A), which includes areas designated as "rural" by the Census Bureau in the urban-rural classification it completes after each decennial census. To implement this change, proposed § 1026.35(b)(2)(iv)(A) provides that an area is rural during a calendar year if it is either (1) a county that meets the Bureau's current rural definition (*i.e.*, a county that is neither in an MSA nor in a micropolitan statistical area that is adjacent to an MSA, as those terms are defined by the U.S. Office of Management and Budget and as they are applied under currently applicable UICs, established by USDA-ERS), or (2) a census block that is not in an urban area, as defined by the Census Bureau using the latest decennial census of the United States. The proposed definition affects the exemption to the escrow requirement for higher-priced mortgage loans in § 1026.35(b)(2)(iii),

[40] Census Bureau, *2010 Census Urban and Rural Classification and Urban Area Criteria*, https://www.census.gov/geo/reference/ua/urban-rural-2010.html. To qualify as an urban area, the territory identified must encompass at least 2,500 people, of which at least 1,500 must reside outside institutional group quarters such as correctional facilities, group homes for juveniles, and mental (psychiatric) hospitals.

the allowance for balloon-payment qualified mortgages in § 1026.43(f), and the exemption from the balloon-payment prohibition on high-cost mortgages in § 1026.32(d)(1)(ii)(C).[41]

The proposed definition of "rural" maintains the bright-line, easy-to-apply county-based test from the current definition, while also bringing into the definition rural pockets within counties that are non-rural under the current rule.[42] Because the Census Bureau's classification is done at the census block level, it provides much more granularity than any county-based metric. To prepare the rural-urban classification, the Census Bureau uses measures based primarily on population counts and residential population density, but also considers a variety of criteria that account for nonresidential urban land uses, such as commercial, industrial, transportation, and open space that are part of the urban landscape.[43] Since the 1950 Census, the Census Bureau has reviewed and revised these criteria as necessary for each decennial census. The Census Bureau completes its rural-urban classification every ten years based on the results of the decennial census, on roughly the same schedule that the USDA-ERS uses in updating its UIC designations, which should provide a relatively stable but up-to-date measure.

In light of the changes proposed to the structure of § 1026.35(b)(2)(iv)(A), the Bureau proposes for technical reasons to move the discussion of the lists of counties provided by the

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[41] The proposed addition of a census block prong in § 1026.35(b)(2)(iv)(A)'s "rural" definition would not affect the scope of the exemption from a requirement to obtain a second appraisal for certain higher-priced mortgage loans in the January 2013 Interagency Appraisals Final Rule, since that exemption applies to credit transactions made by a creditor in a "rural county" as defined in § 1026.35(b)(2)(iv)(A). This definition of "rural county" would be retained in § 1026.35(b)(2)(iv)(A) as proposed § 1026.35(b)(2)(iv)(A)(*1*).

[42] For example, Culpeper County, Virginia is part of the Washington-Arlington-Alexandria, DC-VA-MD-WV MSA and does not currently qualify as "rural" under existing § 1026.35(b)(2)(iv)(A). Because the Census Bureau defined some census blocks within Culpeper County as rural in its most recent rural-urban classification, those portions of the county qualify as rural under proposed § 1026.35(b)(2)(iv)(A) until the next Census Bureau rural-urban classification.

[43] *See Qualifying Urban Areas for the 2010 Census*, 77 FR 18652 (March 27, 2012); *Urban Area Criteria for the 2010 Census*, 76 FR 53030 (Aug. 24, 2011); *Proposed Urban Area Criteria for the 2010 Census*, 75 FR 52174 (Aug. 24, 2010).

Bureau from § 1026.35(b)(2)(iv)(A) and comment 35(b)(2)(iv)-1 to new proposed § 1026.35(b)(2)(iv)(C) and comment 35(b)(2)(iv)-1.iii.A, which are discussed below. The Bureau also proposes revisions to comment 35(b)(2)(iv)-1 that: (1) conform to the changes made to § 1026.35(b)(2)(iv), (2) add a cross-reference to comment 35(b)(2)(iii)-1, and (3) make technical changes for clarity.

The Bureau also proposes to update the example provided in comment 35(b)(2)(iv)-2.i to reflect the new prong that the Bureau proposes to add to the definition. Proposed comment 35(b)(2)(iv)-2.i explains that an area is considered "rural" for a given calendar year based on the most recent available UIC designations by the USDA-ERS and the most recent available delineations of urban areas by the Census Bureau that are available at the beginning of the calendar year. As the proposed comment notes, these designations and delineations are updated by the USDA-ERS and the Census Bureau respectively once every ten years. The comment provides an illustrative example.

The Bureau solicits comment on whether it should add a second prong to the rural definition based on the Census Bureau's urban-rural classification and, if so, whether it should make any modifications to the Census Bureau's classification in doing so. Although the Bureau proposes to maintain the current county-based test as part of the new definition, the Bureau also solicits comment on whether the counties included in the current definition should be expanded, contracted, eliminated, or maintained as is. The Bureau also requests feedback on any alternative approaches to defining "rural" areas in § 1026.35(b)(2)(iv)(A) that commenters believe might be preferable to the Bureau's proposal.

*35(b)(2)(iv)(B)*

*"Underserved"*

Section 1026.35(b)(2)(iv)(B) defines a county as "underserved" during a calendar year if, according to HMDA data for the preceding calendar year, no more than two creditors extended covered transactions, as defined in § 1026.43(b)(1), secured by a first lien, five or more times in the county. It further provides that a creditor may rely as a safe harbor on the list of counties published by the Bureau to determine whether a county qualifies as "underserved" for a particular calendar year. For technical reasons, the Bureau proposes to move the discussion of the lists of counties provided by the Bureau that appears in § 1026.35(b)(2)(iv)(B) and comment 35(b)(2)(iv)-1 to proposed new § 1026.35(b)(2)(iv)(C) and comment 35(b)(2)(iv)-1.iii.A.[44] The Bureau also proposes other technical changes to § 1026.35(b)(2)(iv)(B) and comments 35(b)(2)(iv)-1 and 35(b)(2)(iv)-2.ii and proposes to add a reference in comment 35(b)(2)(iv)-2.ii to the new grace period under § 1026.35(b)(2)(iii)(A).

Although most of the feedback that the Bureau has received relating to the definition of "rural or underserved" has focused on the definition of "rural," some commenters have also suggested that the Bureau's definition of "underserved" is under-inclusive and have urged the Bureau to consider alternative definitions of "underserved." The proposed changes to the "rural" definition discussed above expand the term "rural or underserved" for purposes of the exemption to the escrow requirement for higher-priced mortgage loans in § 1026.35(b)(2)(iii), the allowance for balloon-payment qualified mortgages in § 1026.43(f), and the exemption from the balloon-payment prohibition on high-cost mortgages in § 1026.32(d)(1)(ii)(C). Because these provisions only mention "underserved" when "rural" is listed in the alternative (rural or underserved), the

[44] This proposed move is consistent with a similar move that the Bureau proposes with respect to the safe harbor discussion that currently appears with the "rural" definition in § 1026.35(b)(2)(iv)(A).

Bureau believes that expanding the "rural" definition as proposed would address the concerns that have been raised by commenters about the overall coverage of "rural or underserved." The Bureau has considered alternative definitions but believes that the current definition of "underserved" appropriately identifies areas where the withdrawal of a creditor from the market could leave no meaningful competition for consumers' mortgage business. The Bureau therefore does not propose any substantive changes to the definition of "underserved" at this time.

*35(b)(2)(iv)(C)*

Section 1026.35(b)(2)(iv)(A) and (B) and comment 35(b)(2)(iv)-1 currently provide that a creditor may rely as a safe harbor on the list of counties published by the Bureau to determine whether a county qualifies as "rural" or "underserved" for a particular calendar year. As noted above, the Bureau proposes to move the discussion of these county lists to new § 1026.35(b)(2)(iv)(C)(*1*) and comment 35(b)(2)(iv)-1.iii.A. In light of the expanded definition of "rural," the Bureau also proposes to add two new safe harbor provisions in § 1026.35(b)(2)(iv)(C)(*2*) and (*3*) relating to automated online tools that may be provided by the Bureau or the Census Bureau.

The Bureau proposes technical changes to the safe harbor provision relating to its county lists and also proposes to publish its county lists in the Federal Register. Proposed comment 35(b)(2)(iv)-1.iii.A also states that, to the extent that U.S. territories are treated by the Census Bureau as counties and are neither MSAs nor micropolitan statistical areas adjacent to MSAs, such territories will be included on these lists as rural areas in their entireties.

Because the proposed changes to § 1026.35(b)(2)(iv) create the possibility that some counties would include both rural and non-rural areas, the Bureau has also adjusted the discussion of the county lists in proposed § 1026.35(b)(2)(iv)(C)(*1*) to make it clear that the lists would not include counties that are partially rural and partially non-rural. The Bureau does not believe it would be practical to publish lists of the census blocks that would qualify as rural under proposed § 1026.35(b)(2)(iv)(A)(*2*) because there are approximately 11 million census blocks in the United States.

To assist creditors in implementing the proposed rural definition, the Bureau may develop an automated tool that allows creditors to enter property addresses, both individually and in batches, on the Bureau's public Web site to determine whether the properties are located in a rural or underserved area for the relevant calendar years. The Bureau does not anticipate that such a tool would be available prior to the proposed effective date for this rule, but it proposes that such a tool could provide a safe harbor if and when it becomes available. Specifically, proposed § 1026.35(b)(2)(iv)(C)(*2*) provides that a property shall be deemed to be in an area that is "rural" or "underserved" in a particular calendar year if the property is designated as rural or underserved for that calendar year by any automated tool that the Bureau provides on its public Web site.

Until any tool that the Bureau may develop becomes available, the Bureau anticipates that creditors would use resources provided by the Census Bureau to determine whether proposed § 1026.35(b)(2)(iv)(A)(*2*) is satisfied—*i.e.*, whether a property or batch of properties is not located in an urban area (defined as either an urbanized area or an urban cluster), as delineated by the Census Bureau. The Census Bureau publishes maps, lists, and other reference materials on its Web site.[45] It also currently provides on its Web site an address search function

[45] Census Bureau, *2010 Census Urban and Rural Classification and Urban Area Criteria*, https://www.census.gov/geo/reference/ua/urban-rural-2010.html.

that allows users to enter a property address to obtain census information about the property, including a designation that the property is in an urban area if that is the case.[46] The Bureau proposes that this tool or any similar tool provided by the Census Bureau could be relied on as a safe harbor. Specifically, proposed § 1026.35(b)(2)(iv)(C)(*3*) provides that a property shall be deemed to be in an area that is "rural" or "underserved" in a particular calendar year if the property is not designated as located in an urban area as defined by the most recent delineation of urban areas announced by the Census Bureau by any automated address search tool that the Census Bureau provides on its public Web site for that purpose.

Proposed comments 35(b)(2)(iv)-1.iii.B and C discuss the safe harbors related to these online tools. Proposed comment 35(b)(2)(iv)-1.iii.C clarifies the calendar years for which the Census Bureau's address search tool can be used, by noting that for any calendar year that begins after the date on which the Census Bureau announced its most recent delineation of urban areas, a property is deemed to be in a rural area if the search results provided for the property by any such tool available on the Census Bureau's public Web site do not designate the property as being in an urban area. This is consistent with proposed comment 35(b)(2)(iv)-2.i, which explains that an area is considered "rural" for a given calendar year based on the most recent available UIC designations by the USDA-ERS and the most recent available delineations of urban areas by the Census Bureau that are available at the beginning of the calendar year.

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[46] *See generally* Census Bureau, *Frequently Asked Questions: How can I determine if my address is urban or rural?*, https://ask.census.gov/faq.php?id=5000&faqId=6405 ("The 2010 Urban Areas can be viewed using Reference maps and the TIGERweb interactive web mapping system. In addition, beginning in the fall of 2012, the American FactFinder Address Search Tool will contain urban and rural information."); *see also* Census Bureau, American FactFinder, http://factfinder2.census.gov/faces/nav/jsf/pages/index.xhtml (providing a link to an address search function that allows users to find Census data by entering a street address).

The Bureau solicits comment on whether Regulation Z should provide a safe harbor for automated tools of this nature. The Bureau is also interested in any feedback relating to how it could make the automated tool it is considering developing most useful to industry and other stakeholders as they implement the rural and underserved definitions.

*Section 1026.43 Minimum Standards for Transactions Secured by a Dwelling*

*43(e) Qualified Mortgages*

*43(e)(5) Qualified Mortgage Defined—Small Creditor Portfolio Loans*

Section 1026.43(e)(5) defines a category of qualified mortgages originated by certain small creditors that enjoy special treatment in the ability-to-repay rules. These mortgages must be originated by creditors that meet the origination limit and asset limit in § 1026.35(b)(2)(iii)(B) and (C), and the creditors must hold the loans in portfolio for at least three years after consummation, with certain exceptions. Such a small creditor portfolio loan can be a qualified mortgage even if the borrower's total debt-to-income ratio exceeds the 43 percent debt-to-income ratio limit that otherwise applies to general qualified mortgage loans under § 1026.43(e)(2). Qualified mortgages originated by small creditors are entitled to a safe harbor under the Bureau's ability-to-repay rule if the loan's APR does not exceed the applicable APOR by 3.5 or more percentage points—in contrast to the general qualified mortgage safe harbor which covers loans with APRs that do not exceed APOR by 1.5 or more percentage points.

The Bureau proposes several changes to the commentary to § 1026.43(e)(5) to conform to the Bureau's proposed changes to the origination limit and the asset limit in § 1026.35(b)(2)(iii)(B) and (C). Proposed comment 43(e)(5)-4 regarding creditor qualifications provides that to be eligible to make a qualified mortgage under § 1026.43(e)(5) the creditor has to satisfy the requirements of § 1026.35(b)(2)(iii)(B) and (C), including the Bureau's proposed changes to the origination limit and the asset limit, respectively, and the addition of the grace periods. The Bureau proposes to revise comment 43(e)(5)-8, regarding the transfer of a qualified mortgage to another qualifying creditor prior to three years after consummation, to conform to the proposed origination limit and asset limit in § 1026.35(b)(2)(iii)(B) and (C).

*43(e)(6)(ii)*

Section 1026.43(e)(6) provides for a temporary balloon-payment qualified mortgage that requires all of the same criteria to be satisfied as the balloon-payment qualified mortgage definition in § 1026.43(f) except the requirement that the creditor extend more than 50 percent of its total first-lien covered transactions in counties that are "rural" or "underserved." Pursuant to § 1026.43(e)(6)(ii), this temporary provision applies only to covered transactions consummated on or before January 10, 2016 (the sunset date). The Bureau now proposes to change § 1026.43(e)(6)(ii) to provide that the temporary provision applies only to covered transactions for which the application was received before April 1, 2016. This proposed change gives small creditors more time to understand how any changes that the Bureau may make to the rural definition and lookback period will affect their status, if at all, and to make any required changes to their business practices.[47] It also expands the scope of the temporary balloon-payment qualified mortgage provision to include certain transactions that have not been consummated as of the sunset date but for which the creditor has already received applications. This proposed change also affects the HOEPA balloon-loan provisions, because the Bureau extended the exception to the general prohibition on balloon features for high-cost mortgages under

[47] Qualified mortgages consummated under § 1026.43(e)(6) based on applications received before April 1, 2016 would retain their qualified mortgage status after that date, as long as the other requirements of § 1026.43(e)(6) are met.

§ 1026.32(d)(1)(ii)(C) to allow small creditors, regardless of whether they operate predominantly in "rural" or "underserved" areas, to continue originating balloon high-cost mortgages if the loans meet the requirements for qualified mortgages under §§ 1026.43(e)(6) or 1026.43(f).

The Bureau anticipates finalizing any changes to the rural definition and lookback period in the fall of 2015. Proposed § 1026.43(e)(6)(ii) allows small creditors that are benefiting from the temporary qualified mortgage balloon-loan expansions but that will not meet the rural or underserved definition for calendar year 2016 more time to transition their business practices.[48] The Bureau solicits comment on whether it should change the sunset date in § 1026.43(e)(6)(ii) and whether § 1026.43(e)(6)(ii) should use the date the application was received or the consummation date in applying the sunset date.

*43(f)*

Section 1026.43(f)(1) provides an exemption to the general prohibition on qualified mortgages having balloon-payment features (under § 1026.43(e)(2)(C)) if the creditor satisfies the requirements stated in § 1026.35(b)(2)(iii)(A), (B), and (C) and other criteria are met. Pursuant to § 1026.43(f)(2), a qualified mortgage made under this section, known as a balloon-payment qualified mortgage, immediately loses its qualified mortgage status upon transfer in the first three years after consummation, unless the transfer is to a creditor that satisfies the requirements in § 1026.35(b)(2)(iii)(A), (B), and (C) or one of the other exceptions listed in § 1026.43(f)(2) applies.

[48] For ease of reference for industry participants, this proposed new sunset date under § 1026.43(e)(6)(ii) coincides with the end of the new proposed grace periods in § 1026.35(b)(2)(iii) for otherwise-eligible creditors whose covered first-lien transactions meet all of the applicable tests in § 1026.35(b)(2)(iii)(A) through (C) in calendar year 2014 but not in calendar year 2015.

The Bureau proposes to revise comments 43(f)(1)(vi)-1 and 43(f)(2)(ii)-1 to reflect the proposed revisions that are described in the section-by-section of analysis of § 1026.35 above, including the new grace periods and expanded tests that the Bureau proposes in § 1026.35(b)(2)(iii)(A), (B), and (C), the broader rural definition that the Bureau proposes in § 1026.35(b)(2)(iv)(A), and the safe harbor provisions that the Bureau proposes in § 1026.35(b)(2)(iv)(C). Proposed comment 43(f)(1)(vi)-1.i.A and B also includes updated examples to reflect these changes in the regulation text.

In lieu of listing out the asset limits in comment 43(f)(1)(vi)-1.iii, the Bureau also proposes to include a cross-reference in comment 43(f)(1)(vi)-1.iii indicating that the Bureau publishes notice of the asset limit each year by amending comment 35(b)(2)(iii)-1.iii. The Bureau also proposes technical changes to comments 43(f)(1)(vi)-1, 43(f)(2)-2, and 43(f)(2)(ii)-1.

## VI. Dodd-Frank Act Section 1022(b) Analysis

### *A. Overview*

In developing the proposed rule, the Bureau has considered potential benefits, costs, and impacts.[49] The Bureau requests comment on the preliminary discussion presented below as well as submissions of additional data that could inform the Bureau's consideration of the benefits, costs, and impacts. The Bureau has consulted, or offered to consult with, the prudential regulators, the Federal Housing Finance Agency, the Federal Trade Commission, the U.S.

[49] Specifically, section 1022(b)(2)(A) of the Dodd-Frank Act calls for the Bureau to consider the potential benefits and costs of a regulation to consumers and covered persons, including the potential reduction of access by consumers to consumer financial products or services; the impact on depository institutions and credit unions with $10 billion or less in total assets as described in section 1026 of the Dodd-Frank Act; and the impact on consumers in rural areas.

Department of Agriculture, the U.S. Department of Housing and Urban Development, the U.S. Department of the Treasury, the U.S. Department of Veterans Affairs, and the U.S. Securities and Exchange Commission, including regarding consistency with any prudential, market, or systemic objectives administered by such agencies. The Bureau has also consulted with the Census Bureau on proposed § 1026.35(b)(2)(iv)(A)(*2*).

As discussed in greater detail elsewhere throughout this Supplementary Information, the Bureau proposes several amendments to the Bureau's Regulation Z and official interpretations relating to escrow requirements for higher-priced mortgage loans under the Bureau's January 2013 Escrows Final Rule and ability-to-repay/qualified mortgage requirements under the Bureau's January 2013 ATR Final Rule and May 2013 ATR Final Rule. Since publication of the 2013 Title XIV Final Rules, the Bureau has received extensive feedback on the definitions of "small creditor" and "rural and undeserved areas" with many commenters criticizing the Bureau for defining "rural" and "underserved" too narrowly and urging the Bureau to consider alternative definitions. This proposed rule reflects feedback from stakeholders regarding the Bureau's definitions of small creditor and rural and underserved areas as those definitions relate to special provisions and certain exemptions provided to small creditors under the Bureau's aforementioned rules.

The discussion below considers the benefits, costs, and impacts of the following key provisions of the proposed rule (proposed provisions):

- Raising the loan origination limit for determining eligibility for small-creditor status;
- An expansion of the definition of "rural area" to include (1) a county that meets the current definition of rural county or (2) a census block that is not in an urban area as defined by the Census Bureau; and

- An extension of the temporary two-year transition period that allows certain small creditors to make balloon-payment qualified mortgages and balloon-payment high cost mortgages regardless of whether they operate predominantly in rural or underserved areas.

With respect to these provisions, the discussion considers costs and benefits to consumers and costs and benefits to covered persons. The discussion also addresses certain alternative provisions that were considered by the Bureau in the development of the proposed rule. The Bureau has chosen to evaluate the benefits, costs, and impacts of the proposed rule against the current state of the world.[50] That is, the Bureau's analysis below considers the benefits, costs, and impacts of the proposed provisions relative to the current regulatory regime, as set forth primarily in the January 2013 ATR Final Rule, the May 2013 ATR Final Rule, and the January 2013 Escrows Final Rule.[51] The baseline considers economic attributes of the relevant market and the existing regulatory structure.

The Bureau has relied on a variety of data sources to consider the potential benefits, costs and impacts of the proposed provisions, including the public comment record of various Board and Bureau rules.[52] However, in some instances, the requisite data are not available or are quite limited. Data with which to quantify the benefits of the rule are particularly limited. As a result,

[50] In particular, the Bureau compares the impacts of the proposed provisions against the state of the world after January 2016 if the proposed provisions do not come into effect.

[51] The Bureau has discretion in future rulemakings to choose the relevant provisions to discuss and to choose the most appropriate baseline for that particular rulemaking.

[52] The quantitative estimates in this analysis are based upon data and statistical analyses performed by the Bureau. To estimate counts and properties of mortgages for entities that do not report under HMDA, the Bureau has matched HMDA data to Call Report data and National Mortgage Licensing System data and has statistically projected estimated loan counts for those depository institutions that do not report these data either under HMDA or on the NCUA Call Report. The Bureau has projected originations of higher-priced mortgage loans in a similar fashion for depositories that do not report under HMDA. These projections use Poisson regressions that estimate loan volumes as a function of an institution's total assets, employment, mortgage holdings, and geographic presence.

portions of this analysis rely in part on general economic principles to provide a qualitative discussion of the benefits, costs, and impacts of the proposed rule.

The primary source of data used in this analysis is 2013 data collected under HMDA. The empirical analysis also uses data from the 4th quarter 2013 bank and thrift Call Reports,[53] and the 4th quarter 2013 credit union Call Reports from the NCUA, to identify financial institutions and their characteristics. Unless otherwise specified, the numbers provided include appropriate projections made to account for any missing information, for example, any institutions that do not report under HMDA. The Bureau also utilized the data from the Bureau's Consumer Credit Panel.[54]

Especially in light of some of the comments received by the Bureau that were discussed in the section-by-section analysis, it is worth emphasizing that the Bureau analyzes data from all creditors, both the ones that report under HMDA and the ones that do not, with the exception of non-depository institutions that do not report under HMDA. For HMDA reporters, the Bureau uses the data reported. For HMDA non-reporters, the Bureau uses projections based on the match of the Call Report data with HMDA.

The proposed provisions would expand the number of institutions that are eligible to originate certain types of qualified mortgages and to take advantage of certain special provisions

[53] Every national bank, State member bank, and insured nonmember bank is required by its primary Federal regulator to file consolidated Reports of Condition and Income, also known as Call Reports, for each quarter as of the close of business on the last day of each calendar quarter (the report date). The specific reporting requirements depend upon the size of the bank and whether it has any foreign offices. For more information, see http://www2.fdic.gov/call_tfr_rpts/.

[54] The Consumer Credit Panel is a longitudinal, nationally representative sample of approximately 5 million deidentified credit records from one of the nationwide consumer reporting agencies. The sample provides tradeline-level information for all of the tradelines associated with each credit report record each month, including a commercially-available credit score. This information was used for the analysis of how consumers' credit scores differ depending on the size of the financial institution originating the consumers' mortgage loans.

under the January 2013 ATR Final Rule, the May 2013 ATR Final Rule, the January 2013 Escrows Final Rule, and the 2013 HOEPA Final Rule.[55] The first set of special provisions is tailored to creditors deemed as small (small creditors) without regard to the location of their originations. Small creditors can originate qualified mortgages without regard to the bright-line debt-to-income ratio limit that is otherwise required to meet the Bureau's general qualified mortgage requirements (small creditor portfolio special provision). Qualified mortgages originated by small creditors are entitled to a safe harbor with an APR over 1.5 percentage points over APOR, as long as these loans have an APR of less than 3.5 percentage points over APOR (small creditor portfolio SH special provision).

The second set of special provisions applies only to small creditors that operate predominantly in rural or underserved areas (rural small creditors). Rural small creditors can originate qualified mortgages with balloon-payment features, as long as these loans are kept in portfolio (rural qualified mortgage balloon-payment special provision) and other requirements are met.[56] These qualified mortgages with balloon-payment features are entitled to a safe harbor as long as these loans have an APR of less than 3.5 percentage points over APOR. Also, rural small creditors are generally allowed to originate higher-priced mortgage loans without setting up an escrow account for property taxes and insurance (rural higher-priced mortgage loan escrow special provision).

[55] As explained in the section-by-section analysis above, the exception to the general prohibition on balloon-payment features for high-cost mortgages in the 2013 HOEPA Final Rule would also be affected by the proposed provisions. However, the Bureau believes that the effect of the proposed rule on the rural balloon-payment provision in the 2013 HOEPA Final Rule is relatively small, in terms of both the consumers and covered persons affected, and thus the Bureau does not discuss this effect of the proposed rule in this 1022(b) analysis.

[56] As discussed in the section-by-section analysis, there is also a temporary two-year provision that allows small creditors, regardless of whether they operate predominantly in rural or underserved areas, to originate qualified mortgage balloon-payment loans and high-cost mortgages with balloon-payment features. This proposed rule extends the end-date for that temporary provision.

Among other things, the proposed provisions expand the number of small creditors by changing the origination limit on the number of loans that a small creditor could have originated annually together with its affiliates from no more than 500 to no more than 2,000. The proposed rule's origination limit would also count only loans not held in portfolio by the creditor and its affiliates that originate covered transactions secured by first liens toward that limit. Similar to the currently effective provisions, the proposed provisions include a requirement that creditors have less than $2 billion in total assets (adjusted annually), but under the proposed rule this threshold would apply to the creditor's assets combined with the assets of the creditor's affiliates that originate covered transactions secured by first liens rather than just the creditor's own assets.[57]

Based on 2013 data, the Bureau estimates that the number of small creditors would increase from approximately 9,700 to approximately 10,400 if these proposed provisions are adopted (out of the 11,150 creditors in the United States that the Bureau estimates are engaged in mortgage lending). In 2013, the approximately 700 additional creditors originated about 720,000 loans (roughly 10 percent of the overall residential mortgage market), of which about 175,000 were kept in portfolio. Of these 175,000 portfolio loans, the Bureau estimates that about 15,000

[57] All the numbers below are presented considering the affiliates' assets to the extent that the affiliates' assets are aggregated in the Call Reports, thus the number of newly exempted institutions and the number of loans that they originated could be slightly different from what the Bureau is reporting. The Bureau does not believe that aggregating assets of affiliates that originate covered transactions secured by first liens for the purposes of the $2 billion asset prong would result in many, if any, creditors that would be considered small under the currently effective rule, but would not be considered small under the proposed rule.

were portfolio higher-priced mortgage loans and 88 percent of those had an APR between 1.5 and 3.5 percentage points over APOR.[58]

The proposed provisions also expand the areas deemed rural for the purposes of the rural small creditor special provisions described above. Currently, areas deemed rural are counties that are neither in an MSA nor in a micropolitan statistical area that is adjacent to an MSA. In addition to the current definition, the proposed provisions also count as rural areas census blocks that are deemed rural by the Census Bureau.[59] Based on 2013 data, the Bureau estimates that the number of rural small creditors would increase from about 2,400 to about 4,100 if the proposed provisions are adopted.[60] The additional 1,700 creditors originated about 220,000 loans, out of which 120,000 are estimated to be portfolio loans and about 26,000 of those are estimated to be higher-priced mortgage loans. The Bureau is not able to estimate currently what percentage of these 120,000 portfolio loans are balloon-payment loans.

*B. Potential Benefits and Costs to Consumers and Covered Persons*

*Consumer Benefits*

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[58] The percentage of loans with an APR that was 1.5 to 3.5 percentage points over APOR is based exclusively on HMDA data.

[59] As discussed further above, census blocks deemed rural are census blocks that are not in an urban area (*i.e.*, neither in an urbanized area nor in an urban cluster) as defined by the Census Bureau.

[60] The Bureau used data from several sources to estimate whether a given creditor would be considered rural in 2013 according to both the current state of the world and if the proposed rule were adopted. The Bureau used HMDA data for the creditors that report to the dataset. Since creditors only have to report the census tract of the property's location, the Bureau assumed that a property in a particular census tract has the same chance of being rural as the percentage of that tract's population that lives in rural census blocks (this information is available from the Census Bureau). For the depository institutions that did not report under HMDA, the Bureau is aware of the location of the creditors' branches. The Bureau assumed that mortgage lending is spread equally across a creditor's branches. The Bureau also assumed that if a branch is in a given county, then the same proportion of loans in this branch originated to consumers living in rural or underserved areas as the percentage of population living in rural or underserved areas in that county.
Note that the 4,100 includes creditors that would not have qualified as small but for the proposed rule. However, out of the 700 creditors that would not have qualified as small but for the proposed rule, only around 10 percent qualify as rural even if the proposed provisions expanding rural areas are adopted.

Consumer benefit from the proposed provisions is a potential expansion in access to credit. Access to credit concerns meant to be addressed by the rural small creditor provisions and the small creditor provisions are interrelated, thus the Bureau discusses them jointly in this subsection.[61]

In general, most consumer protection regulations have two effects on consumers. Regulations restrict particular practices, or require firms to provide additional services, in order to make consumers better off. However, restricting firms' practices or requiring additional services might result in firms increasing their prices or discontinuing certain product offerings, potentially resulting in reduced access to credit.

The aforementioned small and rural small creditor special provisions were included in the January 2013 ATR Final Rule and the January 2013 Escrows Final Rule (along with the May 2013 ATR Final Rule) in order to alleviate any potential access to credit concerns. Note that some of these provisions were Congressionally mandated. The proposed provisions expand the number of financial institutions that qualify for these special provisions. Accordingly, there are two effects on consumers that originate their mortgage loans with the creditors that would be exempted if the proposed provisions were finalized: a potential benefit from an increase in access to credit and a potential cost from reduction of certain consumer protections.

As noted above, the potential benefit of the proposed provisions for consumers is a potential increase in access to credit. The magnitude of this potential increase depends on whether, but for the provisions in the proposed rule affecting rural small creditors: (1) financial

[61] Note that there is a difference in the current effect of the rules: currently, the creditors that are small, but not rural, enjoy the same special provisions as rural small creditors under the January 2013 ATR Final Rule and the May 2013 ATR Final Rule due to a temporary two-year provision in the May 2013 ATR Final Rule. This temporary provision is discussed in the section-by-section analysis above.

institutions that would be covered by the proposed provisions would stop or curtail originating mortgage loans in particular market segments or would increase the price of credit in those market segments in numbers sufficient to have an adverse impact on those market segments, (2) the financial institutions that would remain in those market segments would not provide a sufficient quantum of mortgage loan origination at the non-increased price, and (3) there would not be significant new entry into the market segments left by the departing institutions. If, but for the proposed rule, all three of these scenarios would be realized, then the proposed rule increases access to credit.

Analogously, the magnitude of this potential increase in access to credit depends on whether, in the absence of the provisions in the proposed rule affecting small creditors and escrow accounts:[62] (1) financial institutions that would be covered by the proposed provisions have already stopped or curtailed originating mortgage loans in particular market segments or increased the price of credit in those market segments in numbers sufficient to have an adverse impact on those market segments, (2) the financial institutions that remained in those market segments do not provide a sufficient quantum of mortgage loan origination at the non-increased price, and (3) there has not been a significant new entry into the market segments left by the departed institutions. If, but for the proposed rule, all three of these scenarios are realized, then the proposed rule increases access to credit.

The Bureau received comments suggesting that access to credit will indeed be curtailed but for the proposed provisions (or is already curtailed, but would be increased if a rule similar to

[62] Note the difference in baselines: currently, due to the temporary two-year provision discussed in the section-by-section, all the small creditors are eligible for the special provisions that apply to rural small creditors, except for the provisions in the January 2013 Escrows Final Rule.

this proposal is finalized). These comments are discussed in the section-by-section analysis. The evidence provided in these comments appears to be largely anecdotal. The Bureau's data do not refute the commenters' assertions; however, the Bureau does not have the direct evidence to estimate the degree to which the proposed provisions would increase access to credit.

In a series of analyses, the Bureau did not find specific evidence that the proposed provisions would increase access to credit when analyzing data on various consumers' characteristics (credit scores,[63] loan amounts relative to income,[64] availability of smaller amount loans,[65] and pricing[66]), collateral (census tracts with portfolio-only lending[67]), and competition (number of creditors active in a county, even assuming that all the creditors that would be

[63] Using the Bureau's Consumer Credit Panel for 2013, the Bureau analyzed borrowers' credit score distributions at creditors with various yearly origination counts. There was no significant difference between the creditors that would qualify as small if the proposed rule was finalized and larger creditors, including both the median credit scores and the lower tails of the distribution (for example, the 10th percentile of FICO scores).

[64] A relationship lender might help consumers by, potentially, originating loans with a higher DTI ratio because, for example, the relationship lender is aware that the consumer is at a high DTI only temporarily. Using HMDA data, and analyzing the loan-to-income ratio as a proxy for DTI (since both variables are available in HMDA), shows that the median consumer of a small creditor has a loan-to-income ratio of 2.3. The figure is the same for larger creditors.

[65] A commenter suggested that smaller creditors might be originating more loans for smaller amounts (the commenter suggested a threshold of $40,000). According to the Bureau's analysis, while it might be true that smaller creditors make a disproportionate number of smaller amount loans, the majority of the smaller loans are made by larger creditors, and a sizable portion of smaller loans are made by creditors that already enjoy the special provisions under the currently effective rules.

[66] Instead of extending more credit, relationship lenders might be extending cheaper credit if they believe that their consumers are, effectively, less risky. In that case, given similar credit-risk profiles, the Bureau could expect that smaller creditors provide cheaper loans. However, higher-priced mortgage loans comprise on average 8.3 percent of the portfolio of creditors that would be deemed small due to the proposed rule and 22.2 percent of the portfolio of creditors that would be deemed small and rural due to the proposed rule. In comparison, the figure for larger creditors is 4.0 percent.

[67] If the area nearby a property is sparsely populated, a lack of comparable properties for appraisal can be a concern. In 2013, there were about 400 tracts where the only HMDA-reported loans originated were portfolio loans (out of the roughly 73,000 tracts in HMDA). About 200 of these tracts had more than one loan originated in 2013. These 400 tracts had fewer than 1,000 loans between them; of these loans, about 400 were made by creditors that originate over 5,000 loans a year and about 300 were made by creditors that made fewer than 500 loans a year.

small,[68] or small and rural, due to the proposed rule would exit if the proposed rule is not adopted).

However, the Bureau's data are not complete and do not permit the Bureau to analyze various relevant hypotheses. For example, one possible theory that the Bureau's data do not confirm or negate is that there might be a lack of access to credit due to the particular idiosyncrasies of a property despite the fact that other properties in the same census tract are eligible for government-sponsored entity (GSE) backing. These idiosyncrasies could include, for instance, the absence of a septic tank on the property or the availability of running water only on some properties in that census tract.

Note that the presence of competition raises an important point related to some of the industry comments provided to the Bureau. While many commenters asserted access to credit issues, the implicit proof was that some smaller financial institutions could be originating fewer loans. However, even if true, that could simply mean that the same consumer would get a loan from a larger creditor instead. The Bureau's analysis of the data implies that this is at least a possibility.[69]

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[68] The Bureau analyzed HMDA 2013 county-level data. For purposes of the statistics here and below, "counties" is used to refer to counties and county equivalents. The Bureau considered counties where there are currently at most five creditors operating, and at least one of these creditors would qualify as small only if the proposed rule is adopted. The Bureau's analysis shows that there are only a few counties like this, both for the purposes of the small creditor special provisions and for the purposes of the rural small creditor special provisions.
The cutoff of five competitors is arguably enough to ensure a sufficient amount of competition for a close-to-homogenous product. However, the Bureau does not mean to imply that, for example, first-lien covered transactions in a county constitute a market in the antitrust sense.

[69] To the extent that the effect of the already effective rules might shed light on this topic, the January 2013 Escrows Final Rule has a special provision allowing rural small creditors to originate higher-priced mortgage loans without providing an escrow account. Available evidence indicates that, after the rule went into effect in June 2013, rural small creditors were just as likely to begin originating higher-priced mortgage loans as other creditors. Moreover, the counties where rural small creditors that started originating loans operate did not experience an increase in access to credit. *See* Alexei Alexandrov & Xiaoling Ang, *Identifying a Suitable Control Group Based on*

Similarly, many commenters raised concerns that smaller financial institutions lack the economies of scale necessary for effective compliance and implementation of, for example, adjustable-rate mortgage disclosures or escrows. While this might be true, to the extent that outsourcing and contracting have not alleviated this issue, this is only a concern to consumers to the extent that larger creditors would not originate these loans. In other words, the lack of economies of scale is a concern to consumers only to the extent that the market would be less competitive than it would otherwise be if the proposed provisions are finalized.

*Consumer Costs*

The potential cost to consumers of the proposed provisions is the reduction of certain consumer protections as compared to the baseline established by the January 2013 ATR Final Rule, the May 2013 ATR Final Rule, and the January 2013 Escrows Final Rule. These consumer protections include a consumer's private cause of action against a creditor for violating the general ability-to-repay requirements and the requirement that every higher-priced mortgage loan has an associated escrow account for the payment of property taxes and insurance for five years.

In addition, under the January 2013 ATR Final Rule, after January 10, 2016, creditors that do not meet the definition of "small" and "rural or underserved" will not be able to claim qualified mortgage status for any newly-originated balloon-payment loans. Classifying a loan as a qualified mortgage when it would not have been a qualified mortgage otherwise (utilizing the small creditor portfolio special provision or the rural qualified mortgage balloon-payment special

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*Microeconomic Theory: The Case of Escrows in the Subprime Market*, SSRN working paper (Dec. 30, 2014), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2462128.

provision) or making a loan a safe harbor qualified mortgage loan when it would have otherwise been a rebuttable presumption qualified mortgage (utilizing the small creditor portfolio SH special provision) makes it more difficult for consumers to sue their creditor successfully for failing to properly evaluate the consumers' ability to repay while originating the loans.

A creditor may have an incentive to originate loans without considering ability to repay to the full extent. As the Bureau noted in the January 2013 ATR Final Rule, there are at least three reasons why these incentives exist. First, the creditor might re-sell the loan to the secondary market or might have at least a portion of the default risk insured by a third party. In this case, the creditor does not have the privately optimal incentive to verify ability to repay. The December 2014 Credit Risk Retention Final Rule's requirement of "skin in the game" is designed to ameliorate this issue.[70] Second, the loan officer might not have the right incentive to verify a consumer's ability to repay due to internal organization issues: the loan officer might be benefiting from the creditor's eventual profit due to the loan only proximately and, potentially, the loan officer might have a suboptimal compensation scheme (for example, compensating simply based on the volume originated). Third, the creditor is unlikely to consider a consumer's private costs of foreclosure and the negative externality arising from the foreclosure process.[71] In particular, since the Great Depression, balloon-payment loans have been seen by economists

[70] 79 FR 77602 (Dec. 24, 2014).
[71] *See* John Y. Campbell et al., *Consumer Financial Protection*, 25(1) Journal of Economic Perspectives 91, 96 (2011). "[A] rationale for government mortgage policy is a public interest in reducing the incidence of foreclosures, which, as we mentioned, reduce not only the value of foreclosed properties, but also the prices of neighboring properties […]. The negative effect on the neighborhood is an externality that will not be taken into account by private lenders even if their foreclosure decisions are privately optimal."

and consumer advocates as raising particular risks of foreclosure.[72] The provision of a private cause of action solves, to an extent, this negative externality issue.

Counting only the loans that are not kept in portfolio towards the origination limit ensures that a small creditor can always originate more portfolio loans without being concerned with the possibility of crossing the origination limit. The fact that a creditor keeps the loan in portfolio gives the creditor more incentives not to originate a loan that a consumer would not be able to repay: it potentially deals with the "skin in the game" issue described above.

However, a creditor keeping a loan in portfolio does not fully ensure that the creditor will only originate loans that consumers are able to repay. First, as noted above, "the negative effect on the neighborhood is an externality that will not be taken into account by private lenders even if their foreclosure decisions are privately optimal."[73] Second, it is important to note that a loan can be in portfolio (and thus eligible for special provisions provided by the proposed rule), yet fully or almost fully insured by a third party. In these cases, the creditor does not bear the risk for these loans even though the loan is in portfolio: there is no or little "skin in the game."[74] Finally, the loan officer might not be compensated optimally, although advocates of relationship lending suggest that smaller creditors do not suffer from the internal organization problems described above to the same extent as larger creditors. The Bureau requests comment and any data shedding light on the degree of such concerns, particularly at creditors that would be deemed small solely due to the proposed rule.

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[72] *Id*. "In the late 1920s, the dominant mortgage form was a short-term balloon loan that required frequent refinancing. Low house prices and reduced bank lending capacity in the early 1930s prevented many homeowners from refinancing, causing a wave of foreclosures that exacerbated the Depression."

[73] *Id.* at 96.

[74] Note that if the third party is, for example, the FHA, then the loan would currently be a qualified mortgage regardless of whether this proposed rule is finalized.

Escrow accounts protect consumers from a financial shock (sometimes unexpected, especially for first-time buyers) of having to pay the first lump-sum property tax bill all at once, possibly soon after spending much of the household's savings on the downpayment and closing costs.  Recent research argues that postponing that payment by nine months (which an escrow account approximates by spreading payments over time) decreases the probability of an early payment default by 3 to 4 percent.[75]  As noted in the January 2013 Escrows Final Rule, costs to consumers of not having escrow accounts also include the inconvenience of paying several bills instead of one; the lack of a budgeting device to enable consumers not to incur a major expense later on; and the possibility of underestimating the overall cost of maintaining a residence.

The extent of the potential cost to consumers depends on whether, but for the proposed provisions expanding the special provisions of the January 2013 ATR Final Rule and May 2013 ATR Final Rule: (1) creditors that would qualify for special provisions solely due to the proposed provisions would have incentives to originate loans that do not consider consumers' ability to repay despite these loans being in the creditors' portfolios; (2) consumers of these creditors who proved unable to repay would be unable to secure effective loss mitigation options from the creditors that would leave consumers as well off as they would have been without getting a loan that they proved to be unable to repay; and (3) absent the proposed provisions, these creditors would have stronger incentives to consider consumers' ability to repay or the consumers would elect to sue their local lender, would succeed in obtaining counsel to represent them, and would prevail in such suits.  The Bureau does not possess evidence to confirm or deny

[75] *See* Nathan B. Anderson & Jane Dokko, *Liquidity Problems and Early Payment Default Among Subprime Mortgages*, Federal Reserve's Finance and Economics Discussion Series, *available at* http://www.federalreserve.gov/pubs/feds/2011/201109/201109pap.pdf.

whether these conditions are satisfied. Anecdotal evidence suggests that smaller lenders' loans performed better than larger lenders loans through the crisis.

Similarly, the extent of the potential cost to consumers from expanding the special provisions of the January 2013 Escrows Final Rule depends on whether but for the proposed provisions: (1) the creditors that would be exempted solely due to the proposed provisions would not provide escrow accounts for five years despite these loans being in the creditors' portfolios; (2) consumers of these creditors who experienced a shock due to the first-time lump-sum payment and proved to be unable to repay were unable to secure effective loss mitigation options from the creditors that would leave the consumers as well off as they otherwise would have been with an escrow account; and (3) consumers of these creditors actually experience such shocks.

As noted above, the Bureau estimates that the about 1,700 creditors that would be small and rural under the proposed provisions, but not under the currently effective rule, originated about 220,000 loans and 120,000 portfolio loans in 2013. Out of those 120,000 portfolio loans, 26,000 were portfolio higher-priced mortgage loans. The Bureau does not possess a good estimate of what percentage of these 120,000 portfolio loans are balloon-payment loans. Assuming HPML lending continued at the same level among these creditors, about 26,000 loans would lose the mandatory escrow protections; however, many of these creditors might extend escrow protections despite not being subject to a requirement to do so.

The Bureau believes that the approximately 700 creditors that would be small under the proposed provisions, but not under the currently effective rule, originated 720,000 loans, including 175,000 portfolio loans, in 2013. Out of those 175,000 portfolio loans the Bureau estimates that about 15,000 were portfolio higher-priced mortgage loans and 88 percent of those had an APR between 1.5 and 3.5 percentage points over APOR.[76] The Bureau believes that about 13,000 loans would be deemed safe harbor qualified mortgages due to the proposed provisions. The Bureau does not possess a good estimate of what percentage of these 175,000 portfolio loans would not have been qualified mortgages but for the small creditor special provision.

*Covered Person Benefits and Costs*

The creditors that would enjoy the special provisions due to the proposed provisions would experience benefits roughly symmetric to the protections that consumers lose. In particular, creditors that would qualify as rural small creditors would be able to originate qualified mortgage balloon-payment portfolio loans and pass the risk onto consumers, and small creditors could originate portfolio loans that would not be qualified mortgages or safe harbor qualified mortgages otherwise, resulting in a reduced probability of a successful lawsuit.[77] Additionally, rural small creditors would reduce accounting and compliance costs of providing escrow accounts. To be eligible for these benefits, the firms might need to spend a nominal amount on checking whether they qualify for the special provision.

[76] The percentage of loans with an APR that was 1.5 to 3.5 percentage points over APOR is based exclusively on HMDA data.

[77] There are two types of risk that creditors avoid by originating, for example, a succession of five-year balloon loans as opposed to a 30-year fixed rate loan. The first type of risk is the interest rate risk: cost of funds may increase and the fixed rate will be too cheap, in a sense, for current market conditions. This type of risk is almost fully hedged by choosing an appropriate index for a 5/5 adjustable-rate mortgage. The second type of risk is the risk of the deterioration of the consumer's idiosyncratic conditions. For example, if the consumer's credit profile deteriorates or the consumer loses their job, their fixed rate will be too cheap for that consumer's current conditions. Arguably, creditors can project this risk better than individual consumers and are the lowest cost-avoiders, especially if one assumes that moral hazard is not a major concern in this situation (that consumers are not more likely to lose a job simply because they know that their mortgage is a 30-year loan as opposed to a 5-year balloon loan).

Some of these firm benefits could be passed through to consumers in terms of lower prices or better service. Economic theory suggests that the pass-through rate should be higher the more competitive markets are, all else being equal.[78] However, a market being competitive would suggest lesser access to credit concerns. The Bureau does not possess the data required to estimate the applicable pass-through rates, and will therefore not discuss the pass-through possibilities further.

The benefit of originating balloon-payment loans to the firms is cheaper risk management. With balloon-payment loans, both the interest rate risk and the risk of the consumers' credit files deteriorating are borne by the consumers. While the creditor is arguably the lowest cost avoider in both cases, consumers might not realize the riskiness involved in balloon-payment loans, encouraging the creditor to pass on the risk to consumers. The Bureau does not possess a good estimate of what percentage of these creditors' portfolio loans are balloon-payment loans.

The Bureau believes that an additional 1,700 creditors would qualify as small and rural were the proposed provisions adopted. These creditors would not have to provide consumers with escrow accounts when originating higher-priced mortgage loans; however, the Bureau believes that about 1,300 of the 1,700 creditors already originate higher-priced mortgage loans, thus these savings might be small (or none) for these firms since these firms currently have to provide escrow accounts. Note, that the marginal costs of providing an escrow account are small, if not negative: for various reasons, a creditor that has an escrow system established

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[78] *See* Alexei Alexandrov & Sergei Koulayev, *Using the Economics of the Pass Through in Proving Antitrust Injury in Robinson-Patman Cases*, SSRN working paper (Jan. 26, 2015), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2555952.

generally prefers consumers to establish an escrow account even if one is not required by government regulations.

Approximately 700 creditors would be deemed as small due to the proposed provisions. These creditors originated approximately 175,000 portfolio loans in 2013, out of which about 13,000 loans would be deemed safe harbor qualified mortgages due to the proposed provisions. The Bureau does not possess sufficient data to estimate what percentage of these loans would be qualified mortgages solely due to the proposed provisions. Loans being deemed qualified mortgages or safe harbor qualified mortgages imply a reduced risk of losing consumer-initiated ability-to-repay litigation. The Bureau previously estimated that this risk would account for, at most, 0.1 percent of the loan amount.

Note that all 700 creditors are currently not eligible for the small creditor special provision, and thus any sunk costs necessary to transition to originating non-qualified mortgage loans have already been incurred, except for those creditors that have decided not to originate any non-qualified mortgage loans.

To be eligible for these benefits, the creditors might need to spend a nominal amount on checking whether they qualify for the special provisions. Since the proposed provisions would be expanding special provisions and extending qualified mortgage status, covered persons would not experience any costs other than, potentially, a nominal amount to check whether they qualify for the exemptions or extensions of qualified mortgage status.

*Temporary Balloon-Payment Qualified Mortgage Period – Benefits and Costs to Consumers and Covered Persons*

The Bureau is proposing to provide an extension of the two-year temporary special provision that effectively deemed all small creditors rural for the purposes of the rural qualified mortgage balloon-payment special provision.  This proposed temporary special provision, allowing these creditors to make qualified mortgage balloon-payment loans, is applicable (for transactions with mortgage applications received in the first three months of 2016) to any creditor that is currently small regardless of whether they operate predominantly in rural or underserved areas.  The Bureau estimates that there are about 5,700 such creditors, and that they originated about 430,000 loans, out of which about 220,000 were portfolio loans in 2013.  Note, that only the transactions with applications received in the first quarter of 2016 would be eligible for this special provision.  The Bureau does not possess a good estimate of what percentage of these portfolio loans are balloon-payment loans.

The benefits and costs to consumers and to covered persons are identical to the ones discussed above during the discussion of the rural balloon-payment qualified mortgage special provision.  Note that various property idiosyncrasies that might make access to credit an issue in rural areas are less likely for the consumers of these 5,700 creditors since they do not operate predominantly in rural areas, even as defined by the proposed rule.

The Bureau is also proposing an annual grace period for creditors that stop qualifying as either small creditors or small and rural creditors.[79]  Given the proposed origination limit, the Bureau believes that the number of these transitions is likely to be low from year-to-year:  the number of the creditors that are close to the proposed threshold of small is minimal in

[79] Currently, creditors qualify as operating predominantly in rural or underserved areas based on a three-year lookback period:  a creditor is considered as operating predominantly in rural or underserved areas as long as the creditor operated predominantly in rural or underserved areas in any of the three preceding years.  Thus, this proposed provision could potentially deem a creditor that would be rural in January 2016 not rural if the proposed rule is adopted.  However, the Bureau believes that this possibility will not actually occur or, in other words, any small creditor that was operating in predominantly rural or underserved areas in any of the preceding three years according to the current definition would qualify as rural small under the proposed rule.

comparison to the total number qualified (approximately 10,400 small creditors and approximately 4,100 rural small creditors if the proposed provisions are adopted) and rural areas would change only after each decennial Census. Thus the Bureau does not estimate the effect of this provision in this 1022(b)(2) analysis.

*C. Impact on Covered Persons with No More Than $10 Billion in Assets*

The only covered persons affected by the proposed provisions are those with no more than $10 billion in assets. The effect on these covered persons is described above.

*D. Impact on Access to Credit*

The Bureau does not believe that there will be an adverse impact on access to credit resulting from the proposed provisions. Moreover, as described above, the Bureau received comments strongly suggesting that there will be an expansion of access to credit.

*E. Impact on Rural Areas*

The rural small creditor proposed provisions affect only creditors operating predominantly in rural or underserved areas, as defined according to the definition that the Bureau is proposing. These creditors predominantly originate loans to consumers that live in rural areas, thus the vast majority of the up to 120,000 consumers that would be affected by these provisions live in rural areas. The effect of these proposed provisions is described above.

The creditors that would qualify as small if the proposed provisions were adopted are about as well represented in rural as in non-rural counties, according to the current definition of rural, thus there would be no disproportionate effect on rural areas.[80]

*F. Discussion of Significant Alternatives*

[80] If anything, these creditors are overrepresented in non-rural counties.

Instead of proposing that a property is in a rural area if the property is either in one of the counties currently designated as rural by the Bureau or if the property is not in an urban area as designated by the Census Bureau, the Bureau considered proposing that a property is in a rural area only if the property is not in an urban area as designated by the Census Bureau. The effective difference between the two definitions is that under the proposed definition areas designated as urban areas by the Census Bureau that are located in counties currently designated as rural by the Bureau would be classified as rural, but these urban areas would not be classified as rural under the alternative.

For example, Wise County in Virginia (population of about 40,000, density of about 100 people per square mile) is currently designated as a rural area by the Bureau. Under the proposed definition the whole county remains rural. However, under the alternative definition, some census blocks in that county, including most of the census blocks that comprise the town of Wise, Virginia (population of about 3,000, density of about 1,000 people per square mile) would stop being classified as rural areas. A similar example is Gillespie County in Texas (population of about 25,000, density of about 25 people per square mile), which is entirely rural under the current definition and under the proposed definition. Most of the city of Fredericksburg (population of about 11,000, density of about 1,500 people per square mile) in Gillespie County would not be considered rural under the alternative. Overall, about 22 percent of the U.S. population lives in areas that would be deemed as rural if the proposed provisions are finalized. About 19 percent of the U.S. population lives in census blocks that are not in an urban area according to the Census Bureau.

In comparison to this alternative, the proposed provisions allow several hundred small creditors to continue to enjoy the special provisions for creditors operating predominantly in rural or underserved areas.  Under the alternative, these creditors would have to incur the cost of adapting to originating mortgages without enjoying the provisions that they currently enjoy.  Moreover, under the alternative, compliance might become more burdensome for the remaining creditors that would qualify as rural small creditors even if the proposed rule is not finalized: they would not be able to simply check a list of rural counties (as they do now), since parts of these counties would cease to be rural.  These costs, both the cost of adaptation for some creditors and the cost of more complicated compliance for others, are likely fixed, and economic theory suggests that these creditors would not pass these costs on to consumers.

Other consumer benefits and costs and covered persons benefits and costs of these several hundred small creditors ceasing to qualify as rural are similar to the ones described above for the proposed provisions in general.

## VII.  Regulatory Flexibility Act Analysis

The Regulatory Flexibility Act (RFA), as amended by the Small Business Regulatory Enforcement Fairness Act of 1996, requires each agency to consider the potential impact of its regulations on small entities, including small businesses, small governmental units, and small nonprofit organizations.  The RFA defines a "small business" as a business that meets the size standard developed by the Small Business Administration pursuant to the Small Business Act.

The RFA generally requires an agency to conduct an initial regulatory flexibility analysis (IRFA) and a final regulatory flexibility analysis of any rule subject to notice-and-comment rulemaking requirements, unless the agency certifies that the rule will not have a significant economic impact on a substantial number of small entities.[81] The Bureau also is subject to certain additional procedures under the RFA involving the convening of a panel to consult with small business representatives prior to proposing a rule for which an IRFA is required.[82]

Neither an IRFA nor a small business review panel is required for this proposal because the proposal, if adopted, would not have a significant impact on a substantial number of small entities.

The proposed rule does not have a significant economic impact on any small entities.[83] As noted in the Section 1022(b)(2) Analysis, above, the Bureau does not expect that the proposed rule would impose costs on covered persons, including small entities. All methods of compliance under current law would remain available to small entities should these provisions become effective. Thus, a small entity that is in compliance with current law would not need to take any additional action if the proposal were adopted. The Bureau request comments on this analysis and any relevant data.

*Certification*

Accordingly, the undersigned certifies that this proposed rule, if adopted, does not have a significant economic impact on a substantial number of small entities.

**VIII. Paperwork Reduction Act**

Under the Paperwork Reduction Act of 1995 (PRA) (44 U.S.C. 3501 et seq.), Federal agencies are generally required to seek the Office of Management and Budget (OMB) approval

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[81] 5 U.S.C. 601 et seq.

[82] 5 U.S.C. 609.

[83] It is theoretically possible that a creditor qualifies as small under the current definition, but would fail to qualify as small due to the proposed rule provision including in the calculation of the asset limit for small-creditor status the assets of the creditor's affiliates that originate mortgage loans. The Bureau is unaware of any such creditors and the proposed rule requests comments on their prevalence.

for information collection requirements prior to implementation. The collections of information related to Regulation Z have been previously reviewed and approved by OMB in accordance with the PRA and assigned OMB Control Number 3170-0015 (Regulation Z). Under the PRA, the Bureau may not conduct or sponsor, and, notwithstanding any other provision of law, a person is not required to respond to an information collection unless the information collection displays a valid control number assigned by OMB.

The Bureau has determined that this proposed rule does not impose any new or revised information collection requirements (recordkeeping, reporting, or disclosure requirements) on covered entities or members of the public that would constitute collections of information requiring OMB approval under the PRA. The Bureau seeks comment on whether the proposed rule imposes any new or revised information collection requirements.

**List of Subjects in 12 CFR Part 1026**

Advertising, Consumer protection, Credit, Credit unions, Mortgages, National banks, Savings Associations, Recordkeeping requirements, Reporting, Truth in lending.

**Authority and Issuance**

For the reasons set forth in the preamble, the Bureau proposes to amend Regulation Z, 12 CFR part 1026, as set forth below:

**PART 1026—TRUTH IN LENDING (REGULATION Z)**

1. The authority citation for part 1026 continues to read as follows:

**Authority:** 12 U.S.C. 2601, 2603-2605, 2607, 2609, 2617, 5511, 5512, 5532, 5581; 15 U.S.C. 1601 *et seq*.

**Subpart E—Special Rules for Certain Home Mortgage Transactions**

2. Section 1026.35 is amended by revising paragraphs (b)(2)(iii)(A), (B), (C), and (D), (b)(2)(iv)(A) and (B), and adding paragraph (b)(2)(iv)(C) to read as follows:

**§ 1026.35 Requirements for higher-priced mortgage loans.**

* * * * *

(b) * * *

(2) * * *

(iii) * * *

(A) During the preceding calendar year, or, if the application for the transaction was received before April 1, during either of the two preceding calendar years, the creditor extended more than 50 percent of its total covered transactions, as defined by § 1026.43(b)(1), secured by first liens on properties that are located in areas that are either "rural" or "underserved," as set forth in paragraph (b)(2)(iv) of this section;

(B) During the preceding calendar year, or, if the application for the transaction was received before April 1, during either of the two preceding calendar years, the creditor and its affiliates together originated no more than 2,000 covered transactions, as defined by § 1026.43(b)(1), secured by first liens, that were sold, assigned, or otherwise transferred to another person, or that were subject at the time of consummation to a commitment to be acquired by another person;

(C) As of the preceding December 31st, or, if the application for the transaction was received before April 1, as of either of the two preceding December 31sts, the creditor and its affiliates that originate covered transactions, as defined by § 1026.43(b)(1), secured by a first lien, together, had total assets of less than $2,000,000,000; this asset threshold shall adjust automatically each year, based on the year-to-year change in the average of the Consumer Price

Index for Urban Wage Earners and Clerical Workers, not seasonally adjusted, for each 12-month period ending in November, with rounding to the nearest million dollars (see comment 35(b)(2)(iii)-1.iii for the applicable threshold); and

(D) Neither the creditor nor its affiliate maintains an escrow account of the type described in paragraph (b)(1) of this section for any extension of consumer credit secured by real property or a dwelling that the creditor or its affiliate currently services, other than:

(1) Escrow accounts established for first-lien higher-priced mortgage loans on or after April 1, 2010, and before January 1, 2016; or

*     *     *     *     *

(iv) * * *

(A) An area is "rural" during a calendar year if it is:

(*1*) A county that is neither in a metropolitan statistical area nor in a micropolitan statistical area that is adjacent to a metropolitan statistical area, as those terms are defined by the U.S. Office of Management and Budget and as they are applied under currently applicable Urban Influence Codes (UICs), established by the United States Department of Agriculture's Economic Research Service (USDA-ERS); or

(*2*) A census block that is not in an urban area, as defined by the U.S. Census Bureau using the latest decennial census of the United States.

(B) An area is "underserved" during a calendar year if, according to Home Mortgage Disclosure Act (HMDA) data for the preceding calendar year, it is a county in which no more than two creditors extended covered transactions, as defined in § 1026.43(b)(1), secured by a first lien on property in the county five or more times.

(C) A property shall be deemed to be in an area that is “rural” or “underserved” in a particular calendar year if the property is:

*(1)* Located in a county that appears on the lists published by the Bureau of counties that are entirely rural or underserved for that calendar year,

*(2)* Designated as rural or underserved for that calendar year by any automated tool that the Bureau provides on its public Web site, or

(*3*) Not designated as located in an urban area as defined by the most recent delineation of urban areas announced by the Census Bureau by any automated address search tool that the U.S. Census Bureau provides on its public Web site for that purpose.

* * * * *

3. Section 1026.43 is amended by revising paragraph (e)(6) to read as follows:

**§ 1026.43 Minimum standards for transactions secured by a dwelling.**

* * * * *

(e) * * *

(6) *Qualified mortgage defined—temporary balloon-payment qualified mortgage rules.* (i) Notwithstanding paragraph (e)(2) of this section, a qualified mortgage is a covered transaction:

(A) That satisfies the requirements of paragraph (f) of this section other than the requirements of paragraph (f)(1)(vi); and

(B) For which the creditor satisfies the requirements stated in § 1026.35(b)(2)(iii)(B) and (C).

(ii) The provisions of this paragraph (e)(6) apply only to covered transactions for which the application was received before April 1, 2016.

4. In Supplement I to Part 1026—Official Interpretations:

A. Under *Section 1026.35—Requirements for Higher-Priced Mortgage Loans*:

i. Under *Paragraph 35(b)(2)(iii)*, paragraph 1 is revised.

ii. Under *Paragraph 35(b)(2)(iii)(D)(*1*)*, paragraph 1 is revised.

iii. Under *Paragraph 35(b)(2)(iv)*, paragraphs 1 and 2 are revised.

B. Under *Section 1026.43—Minimum Standards for Transactions Secured by a Dwelling:*

i. Under *Paragraph 43(e)(5)*, paragraphs 4 and 8 are revised.

ii. Under *Paragraph 43(f)(1)(vi)*, paragraph 1 is revised.

iii. Under *Paragraph 43(f)(2)*, paragraph 2 is revised.

iv. Under *Paragraph 43(f)(2)(ii)*, paragraph 1 is revised.

The revisions read as follows:

**SUPPLEMENT I TO PART 1026-OFFICIAL INTERPRETATIONS**

SUBPART E—SPECIAL RULES FOR CERTAIN HOME MORTGAGE TRANSACTIONS

* * * * *

*Section 1026.35—Requirements for Higher-Priced Mortgage Loans*

* * * * *

*35(b) Escrow accounts*

* * * * *

*35(b)(2) Exemptions*

* * * * *

*Paragraph 35(b)(2)(iii).*

1. *Requirements for exemption*. Under § 1026.35(b)(2)(iii), except as provided in § 1026.35(b)(2)(v), a creditor need not establish an escrow account for taxes and insurance for a

higher-priced mortgage loan, provided the following four conditions are satisfied when the higher-priced mortgage loan is consummated:

i. During the preceding calendar year, or during either of the two preceding calendar years if the application for the loan was received before April 1, more than 50 percent of the creditor's total covered transactions, as defined in § 1026.43(b)(1), are secured by first liens on properties located in areas that are either "rural" or "underserved," as set forth in § 1026.35(b)(2)(iv).

A. In general, whether this condition (the "more than 50 percent" test) is satisfied depends on the creditor's activity during the preceding calendar year. However, if the application for the loan in question was received before April 1, the creditor may instead meet the "more than 50 percent" test based on its activity during the next-to-last calendar year. This provides creditors with a grace period if their activity meets the "more than 50 percent" test (in § 1026.35(b)(2)(iii)(A)) in one calendar year but fails to meet it in the next calendar year.

B. A creditor meets the "more than 50 percent" test for any higher-priced mortgage loan consummated during a calendar year if a majority of its first-lien covered transactions in the preceding calendar year are secured by properties located in rural or underserved areas. If the creditor's transactions in the preceding calendar year do not meet the "more than 50 percent" test, the creditor meets this condition for a higher-priced mortgage loan consummated during the current calendar year only if the application for the loan was received before April 1 and a majority of the creditor's first-lien covered transactions during the next-to-last calendar year are secured by properties located in rural or underserved areas. The following examples are illustrative:

*1*. Assume that a creditor originated 180 first-lien covered transactions during 2015 and that 91 of these are secured by properties located in rural or underserved areas. Because a majority of the creditor's first-lien covered transactions during 2015 are secured by properties located in rural or underserved areas, the creditor can meet this condition for exemption for any higher-priced mortgage loan consummated during 2016.

*2.* Assume that a creditor originated 180 first-lien covered transactions during 2015, including 90 transactions secured by properties that are located in rural or underserved areas. Assume further that the same creditor originated 200 first-lien covered transactions during 2014, including 101 transactions secured by properties that are located in rural or underserved areas. Assume further that the creditor consummates a higher-priced mortgage loan in 2016 for which the application was received in November 2016. Because the majority of the creditor's first-lien covered transactions during 2015 are not secured by properties that are located in rural or underserved areas, and the application was received on or after April 1, 2016, the creditor does not meet this condition for exemption. However, assume instead that this creditor consummates a higher-priced mortgage loan in 2016 based on an application received in February 2016. The creditor meets this condition for exemption for this loan because the application was received before April 1, 2016, and the majority of the creditor's first-lien covered transactions in 2014 are secured by properties that are located in areas that were rural or underserved.

ii. The creditor and its affiliates together originated no more than 2,000 covered transactions, as defined in § 1026.43(b)(1), secured by first liens, that were not sold, assigned, or otherwise transferred by the creditor or its affiliates to another person, or that were subject at the time of consummation to a commitment to be acquired by another person, during the preceding calendar year or during either of the two preceding calendar years if the application for the loan was received before April 1. For purposes of § 1026.35(b)(2)(iii)(B), a transfer of a first-lien covered transaction to "another person" includes a transfer by a creditor to its affiliate.

A. In general, whether this condition is satisfied depends on the creditor's activity during the preceding calendar year. However, if the application for the loan in question is received before April 1, the creditor may instead meet this condition based on activity during the next-to-last calendar year. This provides creditors with a grace period if their activity falls at or below the threshold in one calendar year but exceeds it in the next calendar year.

B. For example, assume that a creditor and its affiliates together originated 1,500 loans that were not retained in the portfolio of the creditor or its affiliates in 2015 and 2,500 such loans in 2016. Because the 2016 transaction activity exceeds the threshold but the 2015 transaction activity does not, the creditor satisfies this condition for exemption for a higher-priced mortgage loan consummated during 2017 if the creditor received the application for the loan before April 1, 2017, but does not satisfy this condition for a higher-priced mortgage loan consummated during 2017 if the application for the loan was received on or after April 1, 2017.

iii. As of the end of the preceding calendar year, or as of the end of either of the two preceding calendar years if the application for the loan was received before April 1, the creditor and its affiliates that originate covered transactions secured by a first lien, together, had total assets that are less than the applicable annual asset threshold(s). For purposes of § 1026.35(b)(2)(iii)(C), in addition to the creditor's assets, only the assets of a creditor's "affiliate" as defined in § 1026.32(b)(5) that originates covered transactions (as defined by § 1026.43(b)(1)) secured by a first lien, are counted toward the applicable annual asset threshold. A creditor satisfies this criterion for purposes of any higher-priced mortgage loan consummated during 2016, for example, if the creditor (together with its affiliates that originate first-lien covered transactions) had total assets of less than the applicable asset threshold on December 31, 2015. A creditor that (together with its affiliates that originate first-lien covered transactions) did not meet the applicable asset threshold on December 31, 2015 satisfies this criterion for a higher-priced mortgage loan consummated during 2016 if the application for the loan was received before April 1, 2016 and the creditor (together with its affiliates that originate first-lien covered transactions) had total assets of less than the applicable asset threshold on December 31, 2014, which is $2,060,000,000. The asset threshold shall adjust automatically each year based on the year-to-year change in the average of the Consumer Price Index for Urban Wage Earners and Clerical Workers, not seasonally adjusted, for each 12-month period ending in November, with rounding to the nearest million dollars. The Bureau will publish notice of the asset threshold each year by amending this comment. For historical purposes, the prior asset thresholds were:

A. For calendar year 2013, the asset threshold was $2,000,000,000. Creditors that had total assets of less than $2,000,000,000 on December 31, 2012, satisfied this criterion for purposes of the exemption during 2013.

B. For calendar year 2014, the asset threshold was $2,028,000,000. Creditors that had total assets of less than $2,028,000,000 on December 31, 2013, satisfied this criterion for purposes of the exemption during 2014.

C. For calendar year 2015, the asset threshold was $2,060,000,000. Creditors that had total assets of less than $2,060,000,000 on December 31, 2014, satisfied this criterion for purposes of (1) any loan consummated in 2015 and (2) any loan consummated in 2016 for which the application was received before April 1, 2016.

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*Paragraph 35(b)(2)(iii)(D)(1).*

1. *Exception for certain accounts.* Escrow accounts established for first-lien higher-priced mortgage loans for which applications were received on or after April 1, 2010, and before January 1, 2016, are not counted for purposes of § 1026.35(b)(2)(iii)(D). For applications received on and after January 1, 2016, creditors, together with their affiliates, that establish new escrow accounts, other than those described in § 1026.35(b)(2)(iii)(D)(*2*), do not qualify for the exemption provided under § 1026.35(b)(2)(iii). Creditors, together with their affiliates, that continue to maintain escrow accounts established for first-lien higher-priced mortgage loans for which applications were received on or after April 1, 2010, and before January 1, 2016, still qualify for the exemption provided under § 1026.35(b)(2)(iii) so long as they do not establish new escrow accounts for transactions for which they received applications on or after January 1, 2016, other than those described in § 1026.35(b)(2)(iii)(D)(*2*), and they otherwise qualify under § 1026.35(b)(2)(iii).

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*Paragraph 35(b)(2)(iv).*

1. *Requirements for "rural" or "underserved" status.* An area is considered to be "rural" or "underserved" during a particular calendar year for purposes of § 1026.35(b)(2)(iii)(A) if it satisfies either the test for "rural" or the test for "underserved" in § 1026.35(b)(2)(iv). A creditor's originations of covered transactions, as defined by § 1026.43(b)(1), secured by first liens on properties located in such areas are considered in determining whether the creditor satisfies the condition in § 1026.35(b)(2)(iii)(A). See comment 35(b)(2)(iii)-1.

i. Under § 1026.35(b)(2)(iv)(A), an area is rural during a calendar year if it is: a county that is neither in a metropolitan statistical area nor in a micropolitan statistical area that is adjacent to a metropolitan statistical area; or a census block that is not in an urban area, as defined by the U.S. Census Bureau using the latest decennial census of the United States. Metropolitan statistical areas and micropolitan statistical areas are defined by the Office of Management and Budget and applied under currently applicable Urban Influence Codes (UICs), established by the United States Department of Agriculture's Economic Research Service (USDA-ERS). For purposes of § 1026.35(b)(2)(iv)(A)(*1*), "adjacent" has the meaning applied by the USDA-ERS in determining a county's UIC; as so applied, "adjacent" entails a county not only being physically contiguous with a metropolitan statistical area but also meeting certain minimum population commuting patterns. A county is a "rural" area if the USDA-ERS categorizes the county under UIC 4, 6, 7, 8, 9, 10, 11, or 12. Descriptions of UICs are available on the USDA-ERS Web site at *http://www.ers.usda.gov/data-products/urban-influence-codes/documentation.aspx.* A county for which there is no currently applicable UIC (because the county has been created since the USDA-ERS last categorized counties) is a rural area only if all counties from which the new county's land was taken are themselves rural under currently applicable UICs.

ii. Under § 1026.35(b)(2)(iv)(B), an area is underserved during a calendar year if, according to Home Mortgage Disclosure Act (HMDA) data for the preceding calendar year, it is a county in which no more than two creditors extended covered transactions, as defined in § 1026.43(b)(1), secured by a first lien, five or more times in the county. Specifically, a county is an "underserved" area if, in the applicable calendar year's public HMDA aggregate dataset, no more than two creditors have reported five or more first-lien covered transactions with HMDA geocoding that places the properties in that county. For purposes of this determination, because only covered transactions are counted, all first-lien originations (and only first-lien originations) reported in the HMDA data are counted except those for which the owner-occupancy status is reported as “Not owner-occupied” (HMDA code 2), the property type is reported as “Multifamily” (HMDA code 3), the applicant’s or co-applicant’s race is reported as “Not applicable” (HMDA code 7), or the applicant’s or co-applicant’s sex is reported as “Not applicable” (HMDA code 4). The most recent HMDA data are available at *http://www.ffiec.gov/hmda*.

iii. A. Each calendar year, the Bureau applies the “underserved” area test and the “rural” area test to each county in the United States. If the entire county satisfies either test, the Bureau will include the county on a published list of entirely “rural” or “underserved” counties for a particular calendar year. To facilitate compliance with appraisal requirements in § 1026.35(c), the Bureau will also create a list of those counties that are entirely “rural,” without regard to whether the counties are “underserved.” These lists will not include counties that are partially rural and partially non-rural. To the extent that U.S. territories are treated by the Census Bureau as counties and are neither metropolitan statistical areas nor micropolitan statistical areas adjacent to metropolitan statistical areas, such territories will be included on these lists as rural areas in their entireties. The Bureau will post on its public Web site the applicable lists for each calendar year by the end of that year and publish such lists in the Federal Register, to assist creditors in ascertaining the availability to them of the exemption during the following year. Any county that the Bureau includes on its published lists of counties that are entirely “rural” or “underserved” for a particular year is deemed to qualify as a “rural” or “underserved” area for that calendar year for purposes of § 1026.35(b)(2)(iv).

B. The Bureau may provide on its public Web site an automated tool that allows creditors to determine whether properties are located in areas that are rural or underserved according to the definitions in § 1026.35(b)(2)(iv) for a particular calendar year. A property is deemed to be in a rural or underserved area during a particular calendar year if it is identified as being in a rural or underserved area by any such tool that may be provided on the Bureau's public Web site.

C. The U.S. Census Bureau may provide on its public Web site an automated address search tool that indicates if a property is located in an urban area for purposes of the Census Bureau's most recent delineation of urban areas. For any calendar year that began after the date on which the Census Bureau announced its most recent delineation of urban areas, a property is deemed to be in a rural area if the search results provided for the property by any such tool available on the Census Bureau's public Web site do not designate the property as being in an urban area.

2. *Examples.* i. An area is considered "rural" for a given calendar year based on the most recent available UIC designations by the USDA-ERS and the most recent available delineations of urban areas by the U.S. Census Bureau that are available at the beginning of the calendar year. These designations and delineations are updated by the USDA-ERS and the U.S. Census Bureau respectively once every ten years. As an example, assume a creditor makes first-lien covered transactions in Census Block X that is located in County Y during calendar year 2017. As of January 1, 2017, the most recent UIC designations were published in the second quarter of 2013, and the most recent delineation of urban areas was announced in the Federal Register in 2012, *see* U.S. Census Bureau, *Qualifying Urban Areas*, 77 FR 18652 (Mar. 27, 2012). To determine whether County Y is entirely rural during calendar year 2017, the creditor can use USDA-ERS's 2013 UIC designations. If County Y is not entirely rural, the creditor can use the U.S. Census Bureau's 2012 delineation of urban areas to determine whether Census Block X is rural and is therefore a "rural" area for purposes of § 1026.35(b)(2)(iv)(A).

ii. A county is considered an "underserved" area for a given calendar year based on the most recent available HMDA data.  For example, assume a creditor makes first-lien covered transactions in County Y during calendar year 2016, and the most recent HMDA data are for calendar year 2015, published in the third quarter of 2016.  The creditor will use the 2015 HMDA data to determine "underserved" area status for County Y in calendar year 2016 for the purposes of qualifying for the "rural or underserved" exemption for (1) any higher-priced mortgage loans consummated in calendar year 2017 or (2) any higher-priced mortgage loan consummated during 2018 for which the application was received prior to April 1, 2018.

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*Section 1026.43—Minimum Standards for Transactions Secured by a Dwelling*

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*Paragraph 43(e)(5).*

*     *     *     *     *

4. *Creditor qualifications.* To be eligible to make qualified mortgages under § 1026.43(e)(5), a creditor must satisfy the requirements stated in § 1026.35(b)(2)(iii)(B) and (C).  Section 1026.35(b)(2)(iii)(B) requires that, during the preceding calendar year, or, if the application for the transaction was received before April 1, during either of the two preceding calendar years, the creditor and its affiliates together originated no more than 2,000 covered transactions, as defined by § 1026.43(b)(1), secured by first liens, that were sold, assigned, or otherwise transferred to another person, or that were subject at the time of consummation to a commitment to be acquired by another person.  Section 1026.35(b)(2)(iii)(C) requires that, as of the preceding December 31st, or, if the application for the transaction was received before April 1, as of either of the two preceding December 31sts, the creditor and its affiliates that originate

covered transactions, as defined by § 1026.43(b)(1), secured by a first lien, together, had total assets of less than $2 billion, adjusted annually by the Bureau for inflation.

* * * * *

8. *Transfer to another qualifying creditor.* Under § 1026.43(e)(5)(ii)(B), a qualified mortgage under § 1026.43(e)(5) may be sold, assigned, or otherwise transferred at any time to another creditor that meets the requirements of § 1026.43(e)(5)(i)(D). A qualified mortgage under § 1026.43(e)(5) transferred to a creditor that meets these criteria would retain its qualified mortgage status even if it is transferred less than three years after consummation.

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*43(f) Balloon-payment qualified mortgages made by certain creditors.*

*43(f)(1) Exemption.*

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*Paragraph 43(f)(1)(vi).*

1. *Creditor qualifications.* Under § 1026.43(f)(1)(vi), to make a qualified mortgage that provides for a balloon payment, the creditor must satisfy three criteria that are also required under § 1026.35(b)(2)(iii)(A), (B) and (C), which require:

i. During the preceding calendar year or during either of the two preceding calendar years if the application for the transaction was received before April 1, the creditor extended over 50 percent of its total first-lien covered transactions, as defined in § 1026.43(b)(1), on properties that are located in areas that are designated either “rural” or “underserved,” as defined in § 1026.35(b)(2)(iv), to satisfy the requirement of § 1026.35(b)(2)(iii)(A). Pursuant to § 1026.35(b)(2)(iv), an area is considered to be rural if it is: a county that is neither in a metropolitan statistical area, nor a micropolitan statistical area adjacent to a metropolitan statistical area, as those terms are defined by the U.S. Office of Management and Budget; or a census block that is not in an urban area, as defined by the U.S. Census Bureau using the latest decennial census of the United States. A county is considered to be an underserved area if no more than two creditors extend covered transactions secured by a first lien five or more times in that county during a calendar year.

A. The Bureau determines annually which counties in the United States are entirely rural or underserved and publishes on its public Web site lists of those counties to assist creditors in determining whether they meet this criterion. The Bureau may also provide an automated tool on its public Web site that can be used to determine whether specific properties are located in areas that qualify as "rural" or "underserved" according to the definitions in § 1026.35(b)(2)(iv) for a particular calendar year. The U.S. Census Bureau may also provide on its public Web site an automated address search tool that indicates if a specific property address is located in an urban area for purposes of the Census Bureau's most recent delineation of urban areas. For any calendar year that begins after the date on which the Census Bureau announced its most recent delineation of urban areas, a property is located in an area that qualifies as "rural" according to the definitions in § 1026.35(b)(2)(iv) if the search results provided for the property by any such tool available on the Census Bureau's public Web site do not identify the property as being in an urban area.

B. For example, if a creditor originated 100 first-lien covered transactions during 2016 and 90 first-lien covered transactions during 2017, the creditor meets this element of the exception for any transaction consummated during 2018 if at least 46 of its 2017 covered transactions are secured by first liens on properties that are located in one or more counties on the Bureau's lists for 2017 or are located in one or more census blocks that are not in an urban area, as defined by the Census Bureau.

C. Alternatively, if the creditor's 2017 transactions do not meet the test, the creditor satisfies this criterion for any transaction consummated during 2018 for which it received the application before April 1 if at least 51 of its 2016 covered transactions are secured by first liens on properties that are located in one or more counties on the Bureau's lists for 2016 or are located in one or more census blocks that are not in an urban area.

ii. During the preceding calendar year, or, if the application for the transaction was received before April 1, during either of the two preceding calendar years, the creditor together with its affiliates originated no more than 2,000 covered transactions, as defined by § 1026.43(b)(1), secured by first liens, that were sold, assigned, or otherwise transferred to another person, or that were subject at the time of consummation to a commitment to be acquired by another person, to satisfy the requirement of § 1026.35(b)(2)(iii)(B).

iii. As of the preceding December 31st, or, if the application for the transaction was received before April 1, as of either of the two preceding December 31sts, the creditor and its affiliates that originate covered transactions secured by a first lien, together, had total assets that do not exceed the applicable asset threshold established by the Bureau, to satisfy the requirement of § 1026.35(b)(2)(iii)(C).  The Bureau publishes notice of the asset threshold each year by amending comment 35(b)(2)(iii)-1.iii.

*43(f)(2) Post-consummation transfer of balloon-payment qualified mortgage.*

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2. *Application to subsequent transferees.* The exceptions contained in § 1026.43(f)(2) apply not only to an initial sale, assignment, or other transfer by the originating creditor but to

subsequent sales, assignments, and other transfers as well. For example, assume Creditor A originates a qualified mortgage under § 1026.43(f)(1). Six months after consummation, Creditor A sells the qualified mortgage to Creditor B pursuant to § 1026.43(f)(2)(ii) and the loan retains its qualified mortgage status because Creditor B complies with the conditions relating to operating in rural or underserved areas, asset size, and number of transactions. If Creditor B sells the qualified mortgage, it will lose its qualified mortgage status under § 1026.43(f)(1) unless the sale qualifies for one of the § 1026.43(f)(2) exceptions for sales three or more years after consummation, to another qualifying institution, as required by supervisory action, or pursuant to a merger or acquisition.

* * * * *

*Paragraph 43(f)(2)(ii).*

1. *Transfer to another qualifying creditor.* Under § 1026.43(f)(2)(ii), a balloon-payment qualified mortgage under § 1026.43(f)(1) may be sold, assigned, or otherwise transferred at any time to another creditor that meets the requirements of § 1026.43(f)(1)(vi). That section requires that a creditor: (1) Extend over 50 percent of its total first-lien covered transactions, as defined in § 1026.43(b)(1), on properties located in rural or underserved areas; (2) together with all affiliates, originate no more than 2,000 first-lien covered transactions not retained in the portfolio of the creditor or its affiliates; and (3) have, together with its affiliates that originate covered transactions secured by a first lien, total assets less than $2 billion (as adjusted for inflation) at the end of the calendar year. These tests are assessed based on transactions and assets from the calendar year preceding consummation of the transaction or from either of the two calendar years preceding consummation if the application for the transaction was received before April 1 of the calendar year in which the loan was consummated. A balloon-payment qualified mortgage under

§ 1026.43(f)(1) transferred to a creditor that meets these criteria would retain its qualified mortgage status even if it is transferred less than three years after consummation.

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**[THIS SIGNATURE PAGE PERTAINS TO THE PROPOSED RULE TITLED "AMENDMENTS RELATING TO SMALL CREDITORS AND RURAL OR UNDERSERVED AREAS UNDER THE TRUTH IN LENDING ACT (REGULATION Z)"]**

Dated: January 27, 2015.

Richard Cordray

**Richard Cordray,**

*Director, Bureau of Consumer Financial Protection.*