

MEMORANDUM

To: Michael Whipple & Todd Ludlow, Chenoa Fund

From: Benjamin K. Olson & Steven R. vonBerg

Re: Exclusion of Lender and Seller-Paid Costs from Points and Fees

Date: June 5, 2019

This memorandum addresses the treatment of lender and seller-paid costs with respect to the calculation of points and fees under Regulation Z. In short, we believe that, subject to certain limitations, charges that would otherwise be included in points and fees may be excluded if the charge will be paid by the lender or seller. Below, we discuss the relevant regulations and guidance and their application to lender and seller-paid costs.

Please note that, in response to questions raised by sellers, a new section II.C has been added to specifically address the application of seller payments to creditor fees. Conforming edits have been made elsewhere.

I. Regulation Z and Related Guidance

A. The Finance Charge

The finance charge is the starting point of the points and fees calculation for purposes of high-cost loan and qualified mortgage status. Specifically, “[i]n connection with a closed-end credit transaction, points and fees means the following fees or charges that are known at or before consummation ... [a]ll items included in the finance charge under § 1026.4(a) and (b)” unless an exception applies. 12 C.F.R. § 1026.32(b)(1)(i).

The finance charge is the cost of consumer credit expressed as a dollar amount. It includes “any charge payable directly or indirectly by the consumer and imposed directly or indirectly by the creditor as an incident to or a condition of the extension of credit.” 12 C.F.R. § 1026.4(a).

1. *Lender Credits*

The official interpretations of § 1026.4 clarify that a charge paid by the creditor—which is often referred to as a “lender credit”—is not a finance charge because it is not directly or indirectly imposed on the consumer. Specifically, comment 4(a)-2 explains:

Costs of doing business. Charges absorbed by the creditor as a cost of doing business are not finance charges, even though the creditor may take such costs into

consideration in determining the interest rate to be charged or the cash price of the property or service sold. However, if the creditor separately imposes a charge on the consumer to cover certain costs, the charge is a finance charge if it otherwise meets the definition.

Elsewhere, the official interpretations explain that “the terms of the legal obligation between the consumer and the creditor” govern whether a lender credit should be reflected in the disclosures, including the disclosure of the finance charge:

Rebates and loan premiums. In a loan transaction, the creditor may offer a premium in the form of cash or merchandise to prospective borrowers.... Such premiums and rebates must be reflected in accordance with the terms of the legal obligation between the consumer and the creditor. Thus, if the creditor is legally obligated to provide the premium or rebate to the consumer as part of the credit transaction, the disclosures should reflect its value in the manner and at the time the creditor is obligated to provide it.

Comment 17(c)(1)-19.

2. *Seller Credits*

Regulation Z specifically excludes “seller’s points”—more commonly referred to as “seller credits”—from the finance charge. *See* 12 C.F.R. § 1026.4(c)(5) (“The following charges are not finance charges: ... [s]eller’s points.”). The official interpretations state that “[t]he seller’s points mentioned in §1026.4(c)(5) include any charges imposed by the creditor upon the noncreditor seller of property for providing credit to the buyer or for providing credit on certain terms.” Comment 4(c)(5)-1. The interpretations go on to state:

Other seller-paid amounts. Mortgage insurance premiums and other finance charges are sometimes paid at or before consummation or settlement on the borrower’s behalf by a noncreditor seller. The creditor should treat the payment made by the seller as seller’s points and exclude it from the finance charge if, based on the seller’s payment, the consumer is not legally bound to the creditor for the charge. A creditor who gives disclosures before the payment has been made should base them on the best information reasonably available.

Comment 4(c)(5)-2.

B. Points and Fees

As noted above, Regulation Z states that “[a]ll items included in the finance charge under § 1026.4(a) and (b)” are included in points and fees, unless an exception applies. 12 C.F.R. § 1026.32(b)(1)(i). However, despite the longstanding guidance under § 1026.4 on lender and seller payments discussed above, there was some uncertainty within the industry about the application of such payments to the points and fees calculation following the issuance of the Ability-to-Repay/Qualified Mortgage Rule in January 2013.

To address this confusion, the Consumer Financial Protection Bureau (“Bureau”) issued a final rule in October 2013 that, among other things, adopted comment 32(b)(1)-2 to provide “additional clarification concerning the treatment of charges paid by parties other than the consumer, including third parties, for purposes of inclusion in or exclusion from points and fees....” 78 Fed. Reg. 60382, 60408 (Oct. 1, 2013).

1. *Lender Credits*

With respect to lender payments, comment 32(b)(1)-2 states:

Creditor-paid charges. Charges that are paid by the creditor, other than loan originator compensation paid by the creditor that is required to be included in points and fees under § 1026.32(b)(1)(ii), are excluded from points and fees. See §§ 1026.32(b)(1)(i)(A), 1026.4(a), and comment 4(a)-(2).¹

Comment 32(b)(1)-2.iv.

The Bureau explained that this comment was not intended to provide a new interpretation. In fact, the Bureau stated its belief that:

[E]xisting § 1026.4 and supporting commentary already address the treatment of creditor-paid charges for purposes of the finance charge under § 1026.32(b)(1)(i). For example, comment 4(a)-2 states that “[c]harges absorbed by the creditor as a cost of doing business are not finance charges, even though the creditor may take such costs into consideration in determining the interest rate to be charged.” The Bureau disagrees with commenters that suggested additional guidance is needed regarding creditor-paid charges beyond what already exists in Regulation Z and new comment 32(b)(1)-2, but for convenience is adding an express reference to comment 4(a)-2 to the Bureau’s final 32(b)(1)-2 comment.

78 Fed. Reg. at 60410. Consistent with comment 4(a)-2, the Bureau noted that, “to the extent that the creditor recovers the cost of such charges from the consumer, the cost is recovered through the interest rate, which is excluded from points and fees under § 1026.32(b)(1)(i)(A).” *Id.* at 60408.

Based on the foregoing, lender-paid charges (other than lender-paid loan originator compensation) are excluded from points and fees regardless of whether the lender absorbs the fees as a cost of doing business or charges a higher interest rate to provide a lender credit.

¹ The use of parenthesis around “2” in “comment 4(a)-(2)” appears to be a typographical error. As noted elsewhere in this memorandum, the Bureau repeatedly referenced comment 4(a)-2 in the preamble to the final rule adopting comment 32(b)(1)-2.

2. *Seller Credits*

With respect to seller payments, comment 32(b)(1)-2 states:

Seller's points. Seller's points, as described in § 1026.4(c)(5) and commentary, are excluded from the finance charge and thus are not included in points and fees under § 1026.32(b)(1)(i). However, charges paid by the seller for items listed in § 1026.32(b)(1)(ii) through (vi) are included in points and fees.

Comment 32(b)(1)-2.iii.

The Bureau explained that this comment “treats seller’s points consistently with the definition of points and fees in Regulation Z by excluding them from the points and fees calculation (as they are excluded from the finance charge), except in certain instances specified in Regulation Z.” 78 Fed. Reg. at 60409.

The Bureau also acknowledged concerns about “the ability of creditors to determine what third-party paid charges, including seller’s payments, should be included in points and fees—specifically that creditors may be aware that a lump-sum amount was advanced by the seller, but not aware of the breakdown of what exactly was paid for by the advance.” *Id.* To address these concerns, the Bureau included the following language in comment 32(b)(1)-2:

In calculating points and fees in connection with a transaction, creditors may rely on written statements from the consumer or third party paying for a charge, including the seller, to determine the source and purpose of any third-party payment for a charge.

Based on the foregoing, seller-paid charges that would otherwise be included in the finance charge are excluded from points and fees under § 1026.32(b)(1)(i) as long as the creditor has a written statement from the consumer or the seller explaining that the seller’s payment should be applied to those specific charges. However, as discussed below, even if they are excluded from the finance charge, seller-paid charges for items listed in § 1026.32(b)(1)(ii) through (vi) are included in points and fees.²

II. Analysis

As discussed above, charges paid by the lender or seller may generally be excluded from the finance charge and points and fees if certain conditions are met. While we are not aware of any requirements or guidance for demonstrating compliance with these conditions, we believe

² As discussed below, § 1026.32(b)(1)(ii) includes certain types of loan originator compensation in points and fees. While not discussed in detail, points and fees also include the following items even if paid by the seller: (1) charges for real-estate related fees that are excluded from the finance charge under § 1026.4(c)(7) unless the charge is reasonable, the creditor receives no direct or indirect compensation in connection with the charge, and the charge is not paid to an affiliate of the creditor (§ 1026.32(b)(1)(iii)); (2) premiums for credit life, credit disability, credit unemployment, credit property insurance, or similar products (§ 1026.32(b)(1)(iv)); (3) the maximum prepayment penalty that may be charged on the new loan (§ 1026.32(b)(1)(v)); and (4) in a refinancing, the total prepayment penalty incurred by the consumer (§ 1026.32(b)(1)(vi)).

that the following steps are sufficient but not necessarily required. Other methods of demonstrating compliance may also be available.

A. Document the Terms of the Legal Obligation

As discussed above, “[c]harges that are paid by the creditor, other than loan originator compensation paid by the creditor that is required to be included in points and fees under § 1026.32(b)(1)(ii), are excluded from points and fees.” Comment 32(b)(1)-2.iv. Similarly, a creditor can exclude a charge paid by seller from the finance charge and points and fees under § 1026.32(b)(1)(i) based on “a written statement from the consumer or ... the seller” that “determine[s] the source and purpose of [the] payment for [the] charge.” Comment 32(b)(1)-2.iii.

Accordingly, to clearly document the terms of the legal obligation governing the application of lender and seller payments, it would be appropriate to have the consumer execute an addendum to the note or contract agreeing that lender and seller payments will be applied first to amounts that are considered finance charges under Regulation Z, then to other amounts that are considered points and fees under Regulation Z, then to any other closing costs, and finally as a reduction in the principal balance. *See* comment 17(c)(1)-2 (“The legal obligation normally is presumed to be contained in the note or contract that evidences the agreement between the consumer and the creditor. But this presumption is rebutted if another agreement between the consumer and creditor legally modifies that note or contract.”).

A sample of such an addendum is attached as Appendix A. We note that, because comment 32(b)(1)-2 states that the creditor may rely on “written statements from the consumer *or* third party paying for a charge, including the seller,” it does not appear necessary for the seller to sign the addendum.

B. Reflect the Credits Consistently on the Closing Disclosure

We are not aware of any guidance specifically addressing whether or how disclosure of lender or seller-paid items on the Closing Disclosure affects the calculation of the finance charge or point and fees. However, the provisions of Regulation Z governing the Closing Disclosure require creditors to distinguish between “specific” and “general” credits. For example:

When the consumer receives a generalized credit from the creditor for closing costs, the amount of the credit must be disclosed [in the Lender Credits line on page 2] under § 1026.38(h)(3). However, if such credit is attributable to a specific loan cost or other cost listed in the Closing Cost Details tables, pursuant to § 1026.38(f) or (g), that amount should be reflected in the Paid by Others column in the Closing Cost Details tables under § 1026.38(f) or (g).

Comment 38(h)(3)-1; *see also* comment 38(j)(2)(v) (“When the consumer receives a generalized credit from the seller for closing costs ..., the amount of the credit must be disclosed [in the Seller Credits line on page 3]. However, if the seller credit is attributable to a specific loan cost or other cost listed in the Closing Cost Details tables, pursuant to § 1026.38(f) or (g), that amount

should be reflected in the seller-paid column in the Closing Cost Details tables under § 1026.38(f) or (g).”).

A creditor should be able to exclude a lender or seller-paid fee from the finance charge and points and fees regardless of whether that fee is paid using a specific credit or a general credit because, in both cases, the consumer ultimately is not responsible for the charge. However, the Closing Disclosure must “reflect the actual terms of the legal obligation between the parties.” Comment 38-3. Therefore, for consistency with the addendum, the safest approach is for the Closing Disclosure to reflect lender or seller-paid amounts that will be excluded from the finance charge and points and fees in, respectively, the Paid by Others column and the Seller-Paid column on page 2 of the Closing Disclosure.

C. Application of Seller Credits to Creditor Fees

We understand that some in the industry have taken the position that, while creditor fees paid with seller credits may be excluded from the finance charge, those fees must nevertheless be included in points and fees. As discussed below, this does not appear to be the best reading of Regulation Z.

1. *Loan Originator Compensation*

Some have suggested that seller-paid creditor fees must be included in points and fees because they are loan originator compensation under § 1026.32(b)(1)(ii). As noted above, comment 32(b)(1)-2.iii states that “charges paid by the seller for items listed in § 1026.32(b)(1)(ii) ... are included in points and fees.” Subject to certain exclusions, § 1026.32(b)(1)(ii) includes in points and fees “[a]ll compensation paid directly or indirectly by a consumer or creditor to a loan originator, as defined in § 1026.36(a)(1), that can be attributed to that transaction at the time the interest rate is set....” Thus, for example, seller payments cannot be used to offset compensation paid by a creditor to a mortgage broker for purposes of the points and fees calculation.

However, the definition of “loan originator” in § 1026.36(a)(1) only includes creditors in two narrow respects:

- First, a creditor is considered a “loan originator” for purposes of § 1026.36 if it: (i) “engages in loan origination activities;” and (ii) “does not finance the transaction at consummation out of the creditor’s own resources, including by drawing on a bona fide warehouse line of credit or out of deposits held by the creditor.” 12 C.F.R. § 1026.36(a)(1)(i). Therefore, a creditor that does not use table funding for a loan is not a “loan originator” for purposes of the compensation provisions in § 1026.36(d) and (e).
- Second, “[a]ll creditors that engage in any of the ... loan origination activities [listed in § 1026.36(a)(1)(i)] are loan originators for purposes of paragraphs (f) and (g) of this section.” 12 C.F.R. § 1026.36(a)(1)(i). These paragraphs address loan originator qualification requirements (§ 1026.36(f)) and the disclosure of loan originator information (§ 1026.36(g)), rather than loan originator compensation.

Accordingly, while a technical argument could be made that fees paid to a non-table funding creditor is loan originator compensation under § 1026.32(b)(1)(ii) because the creditor is a “loan originator” for qualification and disclosure purposes, that does not appear to be the CFPB’s intent or the best reading of the regulation. For example, in the preamble to the January 2013 final rule amending the points and fees calculation pursuant to the Dodd-Frank Act, the CFPB stated that “‘loan originator’ is defined to include mortgage broker firms and individual employees hired by either brokers or creditors, *but not creditors themselves.*” 78 Fed. Reg. 6408, 6435 (Jan. 30, 2013) (emphasis added). Similarly, when amending § 1026.36(a)(1) based on the definition of “mortgage originator” in the section 1401 of the Dodd-Frank Act, the CFPB noted that the Dodd-Frank Act “expressly excludes creditors (other than creditors in table funded transactions).” 78 Fed. Reg. 11280, 11305 (Feb. 15, 2013).

Further, if creditor fees were included in points and fees as loan originator compensation under § 1026.32(b)(1)(ii), they would be “double counted” to the extent those same fees were also included in the finance charge (*i.e.*, in transactions where the finance charge is not offset by lender or seller credits). Given the dramatic impact of double counting on the points and fees calculation and the amount of time and analysis the CFPB devoted to the issue when implementing the Dodd-Frank Act, the absence of any CFPB discussion of double counting with respect to creditor fees strongly indicates that the CFPB did not believe that creditor fees were loan originator compensation under § 1026.32(b)(1)(ii).³

Finally, the CFPB did not create a special rule—as it did for consumer-paid broker compensation—that conditions the exclusion of seller-paid creditor fees from loan originator compensation under § 1026.32(b)(1)(ii) on the inclusion of those fees in the finance charge under § 1026.32(b)(1)(i). In § 1026.32(b)(1)(ii)(A), the CFPB stated that a creditor is permitted to exclude consumer-paid broker compensation from § 1026.32(b)(1)(ii) *only* if it “already has been included in points and fees under paragraph (b)(1)(i) of this section.” In contrast, nothing in § 1026.32(b)(1) indicates that a seller-paid creditor fee is excluded from points and fees under § 1026.32(b)(1)(ii) only if it is included under § 1026.32(b)(1)(i). Instead, it appears that a seller-paid creditor fee is excluded from § 1026.32(b)(1)(i) because it is not a finance charge *and* from § 1026.32(b)(1)(ii) because it is not loan originator compensation.

2. *Seller’s Points v. Seller Credits*

Some in the industry have suggested that, for purposes of calculating points and fees, there is a distinction between “seller’s points” and “seller credits” such that only “seller’s points” may be excluded. This position appears to be based on comment 32(b)(1)-2.iii.

³ In the January 2013 final rule and a subsequent June 2013 final rule, the CFPB engaged in a detailed analysis to determine when double counting of finance charges and loan originator compensation was appropriate (such as when the consumer pays fees that are finance charges to the creditor and the creditor independently pays loan originator compensation to a mortgage broker) and when it was not (such as when a consumer pays compensation directly to a mortgage broker that is both a finance charge and loan originator compensation). *See* 78 Fed. Reg. at 6432-38; 78 Fed. Reg. 35430, 35442-59 (June 12, 2013). At no point in that analysis did the CFPB suggest that creditor fees were loan originator compensation under § 1026.32(b)(1)(ii).

The first sentence of comment 32(b)(1)-2.iii states that “[s]eller’s points, *as described in § 1026.4(c)(5) and commentary*, are excluded from the finance charge and thus are not included in points and fees under § 1026.32(b)(1)(i).” (Emphasis added.) Section 1026.4(c)(5) does not provide a specific definition of “seller’s points.” However, as discussed above, the commentary to § 1026.4(c)(5) makes clear that seller’s points includes not only seller payments of what are traditionally considered “points” (comment 4(c)(5)-1) but also other types of charges that would be imposed on the consumer if not paid by the seller (comment 4(c)(5)-2).

The second sentence of comment 32(b)(1)-2.iii states that “charges paid by the seller for items listed in § 1026.32(b)(1)(ii) through (vi) are included in points and fees.” However, the fact that a seller-paid item may be included in points and fees under § 1026.32(b)(1)(ii) through (vi) does mean that the creditor must include that item under § 1026.32(b)(1)(i).

Appendix A

ADDENDUM REGARDING SELLER OR LENDER CONTRIBUTIONS

Re: [Property Address]

This addendum is made this _____ day of _____, _____, and is incorporated into and shall be deemed to amend and supplement the [insert name of credit agreement] (the “Note”) between _____ (the “Borrower”) and _____ (the “Lender”) to finance the purchase of the property listed above (the “Property”).

In addition to the covenants and agreements made in the Note and [insert name of security instrument], Borrower and Lender further covenant and agree that any credits or other payments provided to Borrower by the seller of the Property (the “Seller”) or by Lender—including any credits provided for the interest rate chosen by Borrower—will be applied to offset costs that Borrower is required to pay at closing in the order listed:

1. Amounts that are considered “finance charges” under Regulation Z, 12 C.F.R. § 1026.4;
2. Other amounts that are considered “points and fees” under Regulation Z, 12 C.F.R. § 1026.32; and
3. Any other closing costs.

Any remaining credits or other payments will be applied to reduce the principal balance of the loan. Borrower is not legally bound to Lender for any amount paid with a credit or payment provided by Seller or Lender.

BY SIGNING BELOW, Borrower accepts and agrees to the terms and covenants contained in this addendum.

_____ Borrower

_____ Borrower