Construction-to-Permanent Financing Under Dodd-Frank's ATR Rule and QM Safe Harbor

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With interest rates steadily climbing higher and a stagnant housing supply, homebuilders and homebuyers are increasingly looking at other options to fill the housing gap. One obvious solution is new construction. However, compared to existing construction, building a home presents a unique set of challenges—especially when it comes to construction financing and navigating the ability-to-repay requirements introduced by the Dodd-Frank Act.

While the construction financing rules are a bit arcane and rather technical, access to financing for new home construction is an increasingly important policy issue, particularly during a housing shortage.

Ability-to-Repay and Qualified Mortgages

As background, the Dodd-Frank Act introduced ability-to-repay (ATR) requirements for virtually all closed-end residential mortgage loans. It established a presumption of compliance with the ATR requirements—often referred to as a safe harbor—for certain categories of mortgages that meet specific criteria, known as a Qualified Mortgage (QM).[1] Later, following several rounds of rulemaking, the Consumer Financial Protection Bureau (CFPB) finalized regulations for implementing the Dodd-Frank Act's ATR requirements (ATR Rule) and QM safe harbor.

Among other things, the QM safe harbor provides that a loan can't have "toxic" features such as interest-only payments and/or negative amortization, and the points and fees thereon cannot exceed 3 percent of the total loan amount.[2]

As summarized by the CFPB:
The ATR/QM Rule requires a creditor to make a reasonable and good-faith determination of a consumer's ability to repay at or before consummation of a covered mortgage loan. A creditor complies with this ATR requirement if the creditor satisfies the Rule's general ATR standard when originating a loan. Additionally, the creditor is presumed to comply with the ATR requirement with regard to a particular loan the creditor originates if the loan satisfies the criteria to be a QM pursuant to the Rule.[3]

With regards to any consumer credit transaction secured by a dwelling, federal Regulation Z lays out the ATR Rule, including the types of transactions subject to the Rule and the requirements for assessing a borrower's ability to repay.[4] More specifically:

- Section 1026.43(a) covers general applicability;
- Section 1026.43(c) summarizes the ATR requirements, including what a creditor must consider in making its determination;
- Section 1026.43(d) is specific to the refinancing of non-standard mortgages (including interest-only loans, negative amortization loans, and loans with adjustable rates); and
- Section 1026.43(e) explains the QM safe harbor.[5]

In summary, the QM safe harbor provides that if a loan meets the QM requirements, it will be presumed to meet the ATR requirements. More importantly, not all secondary market investors will purchase loans that do not qualify under the QM safe harbor (so-called "non-QM loans"), or if they do, they will only do so pursuant to different—and generally more stringent—underwriting and/or pricing requirements.

However, specifically excluded from certain parts of the ATR Rule is a construction-to-permanent loan that includes a construction phase of 12 months or less.[6] Consequently, what is less certain is whether a construction-to-permanent residential mortgage loan that is exempt from the ATR Rule must, or at least should, qualify under the QM safe harbor. If not, then such loans should at least be eligible for standard pricing and purchase by secondary market investors, even if certain construction-related fees are assessed only during the construction phase.[7] Perhaps more importantly, given current stated policy priorities to not only create more housing but to also create more affordable housing, fewer—not more—burdens should restrict lenders' ability to follow standard processes and pricing when financing new residential real estate construction.

The ATR Rule and Construction Financing

While the ATR Rule generally applies to any consumer credit transaction secured by a dwelling, when the construction phase of a construction-to-permanent loan is 12 months or less, the construction phase is exempt from Sections 1026.43(c)–(f) of the Rule.[8] As such, the construction phase of such a loan is excluded from the ATR requirements and, thus, arguably also the points and fees test set forth in the QM safe harbor.

The Official Commentary to Section 1026.43(e) of the ATR/QM Rule provides further clarification:

> *[T]he construction phase and permanent phase may be treated as separate transactions for the purpose of compliance with § 1026.43(c) through (f), and the construction phase of the loan is exempt from §1026.43(c) through (f), provided the initial term is 12 months or less. .... The permanent phase of the loan is treated as a separate transaction and is not exempt under § 1026.43(a)(3)(iii). It may be a qualified mortgage if it satisfies the appropriate requirements.[9]*

Of note, the ATR Rule does not put a limit on this exemption for the construction phase, and it does not cross-reference any other sections of Regulation Z regarding how a transaction is disclosed to determine if the exemption applies to a specific construction-to-permanent loan. Instead, the ATR Rule clearly exempts the construction phase of all construction-to-permanent loans from the ATR requirements and, thus, arguably, the need to comply with the points and fees test under the QM safe harbor.

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Further, when the CFPB added the exemption for construction-to-permanent loans to the ATR Rule, it explained in the Supplementary Information to the published rule the policy position for the exemption:

> *Typically, such loans have a short construction period, during which payments are made of interest only, followed by a fully amortizing permanent period, often an additional 30 years. Because of this hybrid form, the loans do not appear to qualify for the temporary financing exemption, nor would they be qualified mortgages because of the interest-only period and the fact that the entire loan term will often slightly exceed 30 years. However, such loans may have significant consumer benefits because they avoid the inconvenience and expense of a second closing, and also avoid the risk that permanent financing will be unavailable when the construction loan is due. …. [Consequently,] the Bureau is using its adjustment and exception authority to allow the construction phase of a construction-to-permanent loan to be exempt from the ability-to-repay requirements as a temporary loan; however, the permanent phase of the loan is subject to § 1026.43. Because the permanent phase is subject to § 1026.43, it may be a qualified mortgage if it satisfies the appropriate requirements.[10]*

When read together, the ATR Rule, the Official Commentary, and the CFPB's Supplementary Information are unanimous and make clear that the construction phase of a construction-to-permanent loan (where the construction phase is 12 months or less) is exempt from the Rule.

How a Transaction is Disclosed Does Not Affect the Exemption

Regulation Z's general disclosure requirements set forth the rules regarding how consumer transactions subject to Regulation Z must be disclosed, including rules that describe how a construction-to-permanent loan must be disclosed.[11] However, the statute is clear: "When a multiple-advance loan to finance the construction of a dwelling may be permanently financed by the same creditor, the construction phase and the permanent phase may be treated as either one transaction or more than one transaction."[12] The Official Commentary to Section 17(c) further clarifies that the rule is flexible because such loans have two distinct phases, and it "permits the creditor to give either one combined disclosure for both the construction financing and the permanent financing, or a separate set of disclosures for the [two] phases."[13]

Again, when the CFPB added the exemption for such loans to the ATR Rule, it explained the policy position for the exemption:

> *The Bureau notes that existing §1026.17(c)(6)(ii) provides that construction-to-permanent loans may be disclosed as either a single transaction or as multiple transactions at the creditor's option. Consistent with that provision, the Bureau is using its adjustment and exception authority to allow the construction phase of the construction-to-permanent loan to be exempt from the ability-to-repay requirements.[14]*

The CFPB clearly intended to give lenders flexibility regarding required disclosures in connection with construction-to-permanent loans. As such, regardless of whether a lender combines the construction financing and permanent financing disclosures or provides the borrower with separate sets of disclosures, nothing under either the ATR Rule or Regulation Z's general disclosure requirements speaks to the loss of the exemption based on the method of disclosure.

The Takeaway on Construction Financing and the Secondary Market

When buying or building a home, access to liquidity, financing, and capital markets is critically important. However, as stated above, not all secondary market investors will purchase non-QM loans. Of the investors that are willing to purchase non-QM loans, generally, they will only do so pursuant to different underwriting and/or pricing requirements, which are usually more stringent. Given the dual policy priorities of creating both more housing and more affordable housing, there is a clear and convincing path to interpret regulatory provisions to classify construction-to-permanent loans as being eligible for purchase pursuant to standard residential mortgage loan program terms and financing conditions.

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[1] See CFPB Ability-to-Repay and Qualified Mortgage Rule: Small Entity Compliance Guide, Version 3.1 (April 2021), p. 9–10, https://perma.cc/VTB2-C2N2 [accessed September 25, 2023].

[2] 12 C.F.R. § 1026.43(e)(2). The "points and fees" are determined with reference to 12 C.F.R. § 1026.32(b)(1). Therein, certain finance charges that are known at or prior to closing are included in "points and fees." For a loan greater than $100,000, the points and fees cannot exceed 3 percent of the total loan amount. This loan amount is indexed for inflation, and other dollar limits on "points and fees" apply to loan amounts of $100,000 or less. 12 C.F.R. § 1026.43(e)(3).

[3] See CFPB Ability-to-Repay and Qualified Mortgage Rule: Small Entity Compliance Guide, p. 12.

[4] 12 C.F.R. § 1026.43.

[5] Id. at 1026.43(a), (c), (d), (e).

[6] Id. at 1026.43(a)(3)((iii).

[7] Lenders may be able to offer more affordable note rates of interest with the assessment of certain up-front fees, such as discount points or interest rate buy downs. Some of these fees, however, may be included in the "points and fees" test under the QM safe harbor. Further, construction loan lenders typically charge construction loan-related fees during the construction phase, such as inspection and disbursement fees. While it is often known prior to consummation that such fees will be charged, it is often not known how much these fees will be because the necessity to assess them varies with each home, which is usually subject to local home building and permitting requirements and, increasingly, supply chain issues.

[8] Id.

[9] 12 C.F.R., Part 1026, Supp. I (Part 3), Paragraph 43(a)(3), cmt. 2.

[10] ATR and QM Standards Under the Truth in Lending Act, 78 Fed. Reg. 6408, 6448–6449 (January 30, 2013).

[11] 12 C.F.R. § 1026.17.

[12] Id. at 1026.17(c)(6)(ii).

[13] 12 C.F.R., Part 1026, Supp. I (Part 2), Paragraph 17(c)(6), cmt. 2.

[14] ATR and QM Standards Under the Truth in Lending Act, 78 Fed. Reg. 6408, 6448–6449 (January 30, 2013).

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