HUNTON& WILLIAMS

Client Alert

January 2013

The Essentials: The CFPB's Final "Ability-To-Repay/Qualified Mortgage" Rules

On January 10, 2013, the Consumer Financial Protection Bureau (the "CFPB") issued final rules (the "Ability-to-Repay Rules")[1] amending Regulation Z under the Truth in Lending Act ("TILA") to implement the ability-to-repay requirement for residential mortgage loans and protections from liability for qualified mortgages and certain other consumer protections as required by Sections 1411, 1412 and 1414 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act").

The Ability-to-Repay Rules, included in an 800+-page release, are final but do not take effect for another year (January 10, 2014). The CFPB also issued an additional 184-page "concurrent proposal" with potential amendments to the Ability-to-Repay Rules that address certain issues, such as exemptions for certain state and local housing finance agencies, nonprofit creditors and homeownership stabilization programs, an additional definition of a qualified mortgage for certain loans made and held in portfolio by small creditors such as community banks and credit unions, and inclusion of loan originator compensation in the points and fees calculation. Notwithstanding the pending amendments and delayed effective date, the Ability-to-Repay Rules will have an enormous effect on the residential mortgage lending business and will require substantial work in anticipation of implementation.

The Ability-to-Repay Rules generally require that a "creditor shall not make a [residential mortgage] loan … unless the creditor makes a reasonable and good faith determination at or before consummation that the consumer will have a reasonable ability to repay the loan according to its terms." The Ability-to-Repay Rules also provide a compliance safe harbor for mortgage loans that both satisfy the definition of "qualified mortgage" and are not "higher-priced" mortgages. Higher-priced mortgage loans that constitute qualified mortgages are entitled only to a rebuttable presumption regarding creditors' compliance with the ability-to-repay requirement. The Ability-to-Repay Rules also prohibit prepayment penalties on residential mortgage loans except in limited circumstances.

In this Alert, we summarize some of the most significant features of the Ability-to-Repay Rules from the perspective of the securitization industry. We have not attempted a full outline of the rules and have avoided use of certain defined terms (for example, "covered transactions"). For a complete understanding of the Ability-to-Repay Rules, we refer you to the CFPB's release, which includes, in addition to an explanation of the CFPB's rulemaking process, the text of the Ability-to-Repay Rules and Appendix Q (the standards for determining monthly income and debt), which amend Regulation Z, and the CFPB's Official Interpretations relating to the Ability-to-Repay Rules.

What kinds of transactions are covered by the Ability-to-Repay Rules?

The Ability-to-Repay Rules apply to "any consumer credit transaction that is secured by a dwelling … including any real property attached to a dwelling" other than certain home equity lines of credit and timeshares. In addition, with respect to reverse mortgages and certain types of temporary "bridge" loans or

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[1] Available at http://www.consumerfinance.gov/regulations/ability-to-repay-and-qualified-mortgage-standards-under-the-truth-in-lending-act-regulation-z/.

construction-to-permanent loans, only the provisions relating to prepayment penalties apply. For convenience, we refer to these transactions as “mortgage loans” in the remainder of this Alert.

It is irrelevant under the Ability-to-Repay Rules whether the mortgage creates a first lien or subordinate lien on the related mortgaged property or whether the mortgaged property is the borrower’s principal residence or an investment.

What are the general requirements in making an ability-to-repay determination?

The Ability-to-Repay Rules require a creditor to make a reasonable and good faith determination of a consumer’s ability to repay a proposed mortgage loan based on the following general criteria regarding the borrower:

1. Current or reasonably expected income or assets (excluding the dwelling and real property covered by the mortgage loan);
2. Employment status, if the borrower’s income is relied upon in determining repayment ability;
3. Monthly payment obligation for the proposed mortgage loan, calculated in accordance with the Ability-to-Repay Rules;
4. Monthly payment obligations for any simultaneous borrower loan, if the creditor knows or has reason to know of any simultaneous loan;
5. Monthly payment for mortgage-related obligations such as real estate taxes, insurance premiums and similar charges;
6. Current debt, obligations, alimony and child support;
7. Monthly debt-to-income ratio or residual income; and
8. Credit history.

A creditor must verify the underwriting information on which it relies in making its ability-to-pay determination by using reasonably reliable third-party records, such as copies of tax returns, W-2s, payroll statements, governmental or agency records regarding income from benefits or entitlements and various other sources. (Of particular note, “no-doc” loans will not be able to satisfy the ability-to-repay requirements.) In calculating a borrower’s monthly payment, a lender must use the greater of the fully-indexed rate or introductory teaser rate and a monthly payment that is fully amortizing and substantially equal. In addition, special rules apply for balloon loans, interest-only loans and negative amortization loans.

Appendix Q provides standards for determining a borrower’s income and debts, and incorporates the definitions and standards in HUD Handbook 4155.1, *Mortgage Credit Analysis for Mortgage Insurance on One-to-Four-Unit Mortgage Loans*, with appropriate modifications. Although the detail provided in Appendix Q suggests that it is a trap for the unwary, the CFPB believes these guidelines provide clear, well-established standards for determining whether a loan is a qualified mortgage, and notes that the approach is consistent with the risk-retention regulations proposed pursuant to the Dodd-Frank Act.

Importantly, the Ability-to-Repay Rules do not include any requirement that borrowers make minimum down payments or that creditors consider borrowers’ credit scores when evaluating their ability to repay. Of course, a creditor’s underwriting guidelines may include either or both of these requirements.

In addition, more relaxed rules apply for refinancings from an adjustable-rate mortgage, interest only or negatively amortizing mortgage to a “standard mortgage” with a “materially” lower payment. Rather than making an ability-to-repay determination, the creditor must consider whether the new standard mortgage is likely to prevent default once the mortgage is refinanced.

Do the Ability-to-Repay Rules set forth any bright line rules for making an ability-to-repay determination?

No. As the CFPB notes in the Official Interpretations, the Ability-to-Repay Rules do not provide comprehensive underwriting standards and creditors are free to determine how much income is needed to support a particular extension of credit. Rather, whether a particular ability-to-repay determination is reasonable and was made in good faith will depend on the underwriting standards adopted by the creditor, the facts and circumstances of the particular extension of credit and how the underwriting standards are applied to those facts and circumstances.

What is a "qualified mortgage"?

The general definition. The Ability-to-Repay Rules provide for three types of "qualified mortgages." Under the general definition, a "qualified mortgage" is a mortgage loan:

1. That provides for regular periodic monthly payments that are substantially equal (but excludes negative amortization loans, interest-only loans and balloon loans);
2. That has a term that does not exceed 30 years;
3. For which the total points and fees payable in connection with the consummation of the credit transaction do not exceed specified limits (3 percent of the total loan amount with respect to mortgage loans of $100,000 or more and varying limits for smaller loans);
4. For which the lender has generally complied with the ability-to-repay requirements described above with respect to the underwriting of the mortgage loan; and
5. For which the borrower will have a total or "back-end" debt-to-income ratio (calculated in accordance with the Ability-to-Repay Rules) that does not exceed 43 percent.

The temporary rule. In recognition of the fragile state of the mortgage and credit markets and the need to ensure the availability of credit to a broad base of consumers, the CFPB also has provided for a temporary category of qualified mortgages that meet the first three ability-to-repay requirements above and are eligible to be purchased or guaranteed by either Fannie Mae or Freddie Mac while such entity operates under the conservatorship or receivership of the Federal Housing Finance Agency, insured by the U.S. Department of Housing and Urban Development, or guaranteed by the U.S. Department of Veteran Affairs, the U.S. Department of Agriculture or the Rural Housing Service.

This temporary category of qualified mortgage loans phases out as the referenced agencies issue their own qualified mortgage rules or, in the case of Fannie Mae or Freddie Mac, its conservatorship or receivership ends. In any event, this temporary category of qualified mortgages will expire January 10, 2021.

The temporary rule, of course, would not apply to mortgage loans with principal balances in excess of the amounts eligible for purchase or guarantee by the agencies (so-called "jumbo" loans).

Balloon payment qualified mortgages. Even though the general rule excludes balloon loans, the Ability-to-Repay Rules implement a special provision of the Dodd-Frank Act to treat certain balloon loans as qualified mortgages if they are originated and held in portfolio by small creditors operating in predominantly rural or underserved areas. Balloon payment mortgages must have a term of at least five years, a fixed interest rate, meet certain basic underwriting standards and, although debt-to-income ratios must be considered by the creditor, they are not subject to the 43 percent general requirement. To be considered a balloon payment qualified mortgage, a creditor must originate at least 50 percent of its first-lien mortgages in counties that are rural or underserved (as designated yearly by the CFPB), have less than $2 billion in assets and (along with its affiliates) originate no more than 500 first-lien mortgages per year. Creditors generally must hold balloon payment qualified mortgages on their portfolios for three years in order to maintain their "qualified mortgage" status.

What is the benefit of originating a "qualified mortgage" under the Ability-to-Repay Rules?

A mortgage loan that satisfies the requirements of a "qualified mortgage" will be presumed to have complied with the ability-to-repay requirement of the Ability-to-Repay Rules. The creditor (and its assigns) of a qualified mortgage loan that is not a "higher-priced" mortgage loan will have the benefit of a safe harbor, or a conclusive determination that the creditor has complied with the ability-to-repay requirements. If the qualified mortgage loan is a "higher-priced" mortgage loan, the creditor and its assignees will be presumed to have complied with the ability-to-repay requirement. For purposes of the Ability-to-Repay Rules, a "higher-priced" mortgage loan has an annual interest rate that exceeds the average prime offer rate for a comparable mortgage loan by 1.5 percent or more for a first-lien mortgage loan or 3.5 percent or more for a subordinate-lien mortgage loan.

What is the difference between the safe harbor and the rebuttable presumption?

Creditors of qualified mortgages under the safe harbor are conclusively deemed to have originated the loans in compliance with the ability-to-repay requirements of the Ability-to-Repay Rules. A rebuttable presumption of compliance, on the other hand, can be refuted by a borrower through a showing that the creditor did not make a reasonable and good faith determination of the borrower's ability to repay the mortgage loan at the time the credit transaction was consummated. The Official Interpretations indicate the CFPB's view that a borrower could rebut the presumption by showing that, at the time of consummation, based on information available to the creditor, the borrower's "income, debt obligations, alimony, child support, and the consumer's monthly payment (including mortgage-related obligations) … and any simultaneous loan" would leave the borrower with "insufficient residual income or assets" (excluding from assets the value of the mortgaged property) to meet living expenses (including any recurring and material nondebt obligations of the borrower, such as food, clothing, gasoline and health care). However, the Official Interpretations also note that the longer a borrower demonstrates its actual ability to repay a mortgage loan, without modification or accommodation or following an interest rate adjustment, the less likely the borrower will be able to rebut the presumption.

Because many of the factors necessary for a qualified mortgage determination are fact-sensitive, the safe harbor and rebuttable presumption may provide less protection to creditors and their assignees than may first appear, as borrowers may always challenge compliance with one or more of the factors. In particular, a borrower may challenge the status of a qualified mortgage loan as a defense against foreclosure at any time during the life of the loan. Furthermore, the protections afforded by the safe harbor and the rebuttable presumption for qualified mortgages only apply to claims related to borrowers' ability to repay and do not affect other legal rights available to borrowers.

How long do underwriting and origination records need to be kept?

A lender must retain evidence of its compliance with respect to the Ability-to-Repay Rules for a period of three years after the consummation of the related credit transaction. We note that a longer retention period would be more prudent to address any later challenges to the ability-to-repay determination.

Are there special penalties or remedies for breach of the Ability-to-Repay Rules?

The Dodd-Frank Act creates special remedies for violations of TILA's ability-to-repay requirements (section 129C(a)). A borrower who brings a timely action against a creditor for failure to comply with the ability-to-repay requirements may be able to recover special statutory damages equal to all finance changes and fees paid by the borrower (unless the creditor demonstrates that the failure to comply is immaterial) in addition to actual damages, TILA's other statutory damages, court costs and attorneys' fees.

The Dodd-Frank Act also provides that the statute of limitations for violations of TILA section 129C is three years from the date of the violation (as compared with one year for most other TILA violations).

TILA (as amended by the Dodd-Frank Act) also provides that a borrower may assert a violation of the ability-to-repay requirements "as a matter of defense by recoupment or setoff" when a creditor or its assignee or agent initiates a foreclosure. The amount of recoupment or setoff is limited, with respect to special statutory damages, to no more than three years of finance charges and fees, but includes actual and statutory damages as well as costs and attorney's fees.

Limitations on Prepayment Penalties

The Ability-to-Repay Rules also include limitations on the use of prepayment penalties. A mortgage loan cannot include a prepayment penalty unless the prepayment penalty is otherwise permitted by law, the loan has a fixed interest rate, the mortgage loan is a qualified mortgage and the transaction is not a "higher-priced loan" under Regulation Z (not to be confused with a "higher-priced" qualified mortgage). In addition, prepayment penalties may not apply more than three-years after consummation of the loan, and cannot exceed 2 percent of the outstanding loan balance within the first two years and 1 percent of the outstanding loan balance during the third year. Creditors also must offer borrowers an alternative loan that does not include a prepayment penalty in accordance with the requirements of the Ability-to-Repay Rules.

How will the Ability-to-Repay Rules affect mortgage loan originations, sales, servicing and securitizations?

Although it is too soon to say, the Ability-to-Repay Rules may result in reduced credit availability and higher borrowing costs to cover the costs of compliance, despite the CFPB's attempt to balance the needs of borrowers and creditors (and their assignees). Some types of residential mortgage loans, "no-doc" loans for example, will no longer be available. The ability of borrowers to raise new defenses to foreclosure on defaulted mortgage loans also may lead to increased foreclosure costs, extend foreclosure timelines (although this may be less likely for seasoned mortgages) and increase the severity of loan losses. Increased repurchase and indemnity requests and servicer expenses and higher guaranty fees and subordination levels also may result.

In any event, creditors and assignees must carefully evaluate the Ability-to-Repay Rules and implement policies and procedures designed to ensure compliance with the rules and proper identification of qualified mortgages.

Our partner Ronald L. Rubin, former enforcement attorney in the Supervision, Enforcement and Fair Lending Division of the CFPB, assisted in the preparation of this Alert. Please visit http://www.hunton.com/ronald_rubin/ for more information regarding Ron's experience at the CFPB and at Hunton & Williams LLP.

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