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A legal update from Dechert's Finance and Real Estate and Financial Institutions Groups

Federal Reserve's Proposed Rule to Implement the Ability-to-Repay Requirements for Residential Mortgage Loans and its Impact on Lenders and RMBS Investors

The Board of Governors of the Federal Reserve System (the "Board") on May 11, 2011 published a proposed rule[1] concerning implementation of the ability-to-repay requirements imposed by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Act"). Comments on the proposed rule may be submitted to the Board at *http://www.federalreserve.gov* on or before July 22, 2011.

The Act amends the Truth in Lending Act ("TILA") to prohibit creditors from making mortgage loans without regard to the consumer's repayment ability. The Act's underwriting requirements are substantially similar but not identical to the ability-to-repay requirements for higher-priced mortgage loans adopted in July 2008 under the Home Ownership and Equity Protection Act[2] ("HOEPA"). However, unlike the HOEPA rule, the proposed rule is not limited to higher-priced mortgage loans or loans secured by the borrower's principal dwelling. The proposed rule's broader scope applies to all consumer credit transactions secured by a dwelling, including principal and non-principal dwellings (but excluding an open-end credit plan, timeshare plan, reverse mortgage or temporary loan). The proposed rule also (i) implements the Act's limits on prepayment penalties; (ii) requires lenders to retain evidence of compliance with the rule for three years after a loan is made and (iii) provides standards for complying with the ability-to-repay requirement.

The Act prohibits a lender from making a mortgage loan unless the lender makes a reasonable and good faith determination, based on verified and documented information, that the borrower will have a reasonable ability to repay the loan.

The proposal provides four options for complying with the ability-to-repay requirement:

- First, a creditor can meet the general ability-to-repay standard by originating a mortgage loan for which the lender considers and verifies the following eight underwriting factors in determining repayment ability and for which the mortgage payment calculation is based on a fully indexed rate: (i) current or reasonably expected income or assets; (ii) current employment status; (iii) the monthly payment on the mortgage; (iv) the monthly payment on any simultaneous loan; (v) the monthly payment for mortgage-related obligations; (vi) current debt obligations; (vii) the monthly debt-to-income ratio and (viii) credit history.

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1 Board of Governors of the Federal Reserve, Regulation Z; Truth in Lending –RIN No. 7100-AD 75, *available at* http://www.gpo.gov/fdsys/pkg/FR-2011-05-11/pdf/2011-9766.pdf.

2 15 U.S.C. §§ 1637 and 1647.

- Second, a lender can originate a "qualified mortgage," which provides special protection from liability under the Act (a "Qualified Mortgage"). The Board noted that the Act is unclear on whether this protection is intended to be a "safe harbor" from the repayment ability requirement or merely a "rebuttable presumption of compliance" proposing two alternative approaches. One alternative operates as a legal safe harbor and defines a Qualified Mortgage as one in which (i) the loan does not contain negative amortization, interest-only payments or balloon payments or a loan term exceeding 30 years; (ii) the total points and fees do not exceed 3% of the total lien amount; (iii) the borrower's income or assets are verified and documented and (iv) the underwriting of the mortgage (a) is based on the maximum interest rate in the first five years; (b) uses a payment schedule that fully amortizes the loan over the loan term and (c) takes into account any mortgage-related obligations. The other alternative provides a rebuttable presumption of compliance and defines a Qualified Mortgage as including the criteria in the "safe harbor" alternative plus the following additional criteria: (i) the borrower's employment status; (ii) the monthly payment for any simultaneous loan; (iii) the borrower's current debt obligations; (iv) the total debt-to-income ratio and (v) the borrower's credit history.

- Third, a creditor can refinance a "non-standard mortgage" into a "standard mortgage" (i.e., one that does not provide for negative amortization, interest-only payments or balloon payments and that has limited points and fees). This is intended to encourage streamlined refinancings designed to quickly refinance a borrower out of a risky mortgage and into a more stable product. Under this option, the lender does not have to verify the borrower's income or assets.

- Fourth, a small lender operating predominantly in rural or underserved areas can originate a balloon-payment Qualified Mortgage. This option is intended to accommodate community banks that make balloon loans to hedge against interest rate risk by permitting such lenders to make a balloon-payment Qualified Mortgage loan, as long as the loan term is five years or more and the payment calculation is based on the scheduled periodic payments (excluding the balloon payment).

Impact of the Proposed Rule on Residential Mortgage Lenders and RMBS Investors

There are several reasons why the proposed rule will fundamentally change the playing field for residential mortgage lenders.

1. **Scope of Liability**. The liability for originating a loan that does not satisfy the proposed rule is substantial. Assignees of such loans may also be subject to liability. In addition to the usual TILA remedies, there are enhanced civil remedies and the state attorneys general are authorized to bring actions for violations of the ability-to-repay rule for a three year period. A violation of these ability to pay requirements may also prevent a lender from foreclosing on a defaulting borrower. As described above, unlike prior ability-to-repay requirements, the scope of this proposed rule is very broad and applies to all residential mortgage lending.

2. **Safe Harbor versus Rebuttable Presumption**. In light of the substantial potential liability for noncompliance, a safe harbor for Qualified Mortgages will therefore be very attractive to mortgage lenders and assignees of those mortgage loans (including purchasers of whole loan pools and RMBS investors). The definition of Qualified Mortgage may come to define the scope of all mortgage loans originated in the United States. The scope of the definition and how difficult it is to measure compliance may have a significant impact on the availability and price of mortgage credit for all types of borrowers. A poorly drafted definition with requirements that are difficult for diligence firms to measure would be a significant setback for the mortgage industry, and, in turn, potential borrowers. Embedded in this definition is the scope of what constitutes "points and fees" and whether a specific debt-to-income ratio should be set. Each of these elements of the definition will have a substantial impact on the industry. Moreover, there is a significant issue that needs to be resolved in the final rules: whether satisfying the requirements of a Qualified Mortgage was intended by Congress to be a safe harbor from the ability-to-repay requirement (a much better standard for lenders) or merely a presumption of compliance that may be rebutted by the borrower. If it is a safe harbor, the lender would only be liable if (i) the borrower proves that the loan is not a Qualified Mortgage and (ii) the lender was not able to prove that the loan meets the ability-to-repay test. With the presumption of compliance alternative, the borrower can rebut the presumption of compliance with evidence that the loan did not meet the ability-to-repay test.

3. **Uncertainty Surrounding the Consumer Financial Protection Bureau ("CFPB")**. The proposed rule was drafted by the Board but jurisdiction for preparing and implementing the final rule passes to the CFPB on July 22, 2011 when comments are due. Drafting a final rule will be one of the first tasks of the CFPB and it is difficult to predict at this point how the CFPB will proceed. In particular, it remains to be seen whether the CFPB will agree with the background analysis conducted by the Board that supports its drafting of the proposed rule or with the thrust of the proposed rule.

4. **Qualified Mortgage versus QRM**. The definition of Qualified Residential Mortgage ("QRM") will create a class of mortgage loans exempt from the risk retention requirements proposed under the Act ("Risk Retention Requirements"). The QRM requirements are the subject of a separate rulemaking proceeding that now has a comment deadline of August 1, 2011 (See our May *DechertOnPoint* "Risk Retention Proposal for Residential Mortgages Comes into Focus") The Act specifies that the definition of QRM may not be broader in scope than a Qualified Mortgage. Together these two definitions will determine the shape of the RMBS market and it is essential that the definitions fit together in a way that preserves the flow of mortgage credit and makes measuring compliance straightforward.

Key Issues to Consider

The following is a list of key issues that participants in the residential mortgage securitization market should consider.

1. **Definition of Qualified Mortgage**. The two proposed alternatives have very different requirements. The requirements for the presumption of compliance alternative essentially require the lender to satisfy the same burdens as would be required under the ability-to-repay test. We expect that residential mortgage lenders will want to either express a view on the proposed alternatives or propose a new approach. For example, they may want to comment on whether the final rules should specify a particular debt-to-income ratio.

2. **Effect of Satisfying Definition of Qualified Mortgage**. We expect that residential mortgage lenders will want to comment in support of a true "safe harbor" from compliance with the ability-to-repay test so there is more legal certainty surrounding the issue of avoiding liability for non-compliance.

3. **Points and Fees Test**. The Board has proposed two alternative approaches to determining the maximum amount of points and fees that may be charged to a borrower under the Qualified Mortgage definition. Within the subject of points and fees, there are also questions as to what should be included or excluded from the test regardless of which alternative is chosen.

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