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BANKING AND FINANCIAL INSTITUTIONS CLIENT ALERT

CFPB Finalizes Ability-to-Repay Rule for Mortgage Lenders, Defines "Qualified Mortgage" and Proposes Exemption to Ability-to-Repay Rule for Community Banks and Credit Unions

On Thursday, January 10, 2013, the Consumer Financial Protection Bureau (CFPB) released its final rule on the ability-to-repay requirements, including the definition of "Qualified Mortgage," that was mandated by the Truth-in-Lending Act, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act. The rule requires lenders to consider and evaluate whether prospective borrowers have the ability to repay their mortgage loans over the long term and seeks to prohibit what the CFPB has identified as "risky lending practices" that contributed to the 2008 housing crisis. The type of mortgage loans covered by the new rule includes traditional residential mortgages and any consumer credit transaction that is secured by a dwelling, subject to certain enumerated exceptions. In addition, the CFPB has proposed an amendment to this rule that would add other exemptions from the ability-to-repay requirements. The rule will become effective on January 10, 2014.

Requirements of the Ability-to-Repay Rule

Under the rule, in determining whether a borrower has the ability to repay a mortgage loan, lenders must obtain the borrower's financial information from a reliable third-party. At a minimum, lenders must document the borrower's employment status, income and assets, current debt obligations, alimony, child support, credit history, monthly payments on the mortgage loan, monthly payments on any other mortgages on the same property and monthly payments for mortgage related obligations. Lenders may no longer offer no-doc or low-doc loans, where lenders made quick sales by not requiring any, or requiring very limited, documentation. Lenders must evaluate the borrower's financial information and conclude that the borrower has the ability to repay the loan. Additionally, lenders may no longer base their evaluation of a borrower's ability to repay on teaser rates. Instead, a lender must determine the borrower's ability to repay both the principal and the interest over the long term.

Although the rule sets forth specific information requirements for lenders in making their determinations, it leaves to their discretion the particular underwriting model they may choose to use to comply with these requirements. The information and other evidence compiled by lenders in making their ability to repay determinations must be maintained for three (3) years after making a mortgage loan.

The rule provides an exemption from the ability-to-pay requirements for borrowers attempting to refinance a risky or "non-standard" mortgage to a more stable, "standard" loan if certain conditions are met. A "non-standard" mortgage under the rule is a mortgage that can lead to payment "shock" and that can result in default, and includes loans such as adjustable rate mortgages, interest-only loans, and negative amortization loans. A "standard" mortgage under the rule must have required characteristics such as, among others, a fixed interest rate for five (5) years, lower monthly payments and total points and fees that do not exceed 3 percent of the loan amount.

Presumed Compliance with the Ability-to-Repay Rule - Qualified Mortgages

Lenders will be presumed to have satisfied the ability-to-repay requirements of the rule for mortgage loans that are "Qualified Mortgages," which are mortgages that generally are available only to people who have a debt-to-income ratio less than or equal to 43 percent and which:

- do not include points and fees paid by the consumer in excess of 3 percent of the total loan amount, although certain "bona fide discount points" are excluded for prime loans; and

- do not include toxic loan features, such as terms that exceed 30 years, interest-only payments, balloon payments (subject to the exception described below), or negative-amortization payments where the principal amount increases.

Certain balloon-payment mortgage loans also qualify as Qualified Mortgages if the loans are originated by lenders in rural or underserved areas. To qualify, these loans must have a fixed interest rate, a term of at least five (5) years and meet certain underwriting criteria. Further, for these mortgage loans to qualify as Qualified Mortgages, the lenders must have less than $2 billion in assets, originate at least 50 percent of its first-lien mortgage loans in counties that are rural or underserved and originate no more than 500 first-lien mortgage loans per year.

The rule includes a temporary provision for certain Qualified Mortgages in order to provide a transitional period "for creditors to adjust to the new requirements of the final rule as well as to changes in other regulatory, capital, and economic conditions." This temporary provision expands the definition of a Qualified Mortgage to include loans that do not satisfy the 43 percent debt-to-income ratio threshold, but otherwise meet the standards set by Fannie Mae, Freddie Mac or other government housing agencies. This temporary provision will expire in a maximum of seven (7) years.

In addition, the CFPB defined two (2) types of Qualified Mortgages that have different protective features for borrowers and different legal consequences for lenders:

- *Qualified Mortgages with a rebuttable presumption.* Lenders offering higher-interest mortgage loans, which are typically given to borrowers with insufficient or weak credit history, will be presumed to have determined that the borrower has an ability to repay the loan. However, borrowers can challenge that presumption by proving that they did not, in fact, have sufficient income to repay the mortgage loan they were given.

- *Qualified Mortgages that provide a safe harbor for lenders.* With respect to those Qualified Mortgages that are lower-priced, generally because the borrower presents fewer credit risks, lenders will be provided a safe harbor protecting them against challenges by borrowers claiming that a lender did not comply with the ability-to-repay rules. The safe harbor does not preclude borrowers from challenging lenders if the loan does not otherwise meet the definition of a Qualified Mortgage or for violating any other federal consumer protection.

Proposed Ability-to-Repay Amendments

Also on January 10, 2013, the CFPB proposed and requested comments on certain amendments to the ability-to-repay rule that include:

- A provision to give Qualified Mortgage status to mortgage loans originated by smaller creditors, such as community banks and credit unions which originate and hold mortgage loans in their own portfolios;

- Exemptions for:
  - nonprofit creditors that work to help low- to moderate-income consumers obtain affordable housing;
  - housing finance agencies and lenders participating in housing finance agency programs intended to foster community development; and
  - homeownership stabilization programs that work to prevent foreclosure.

The CFPB has stated that its goal is to finalize these proposals this year and have them go into effect simultaneous with the effectiveness of the ability-to-repay rule in January 2014. The CFPB's ability-to-pay rule is available at: http://www.consumerfinance.gov/regulations/.

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