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Dechert LLP

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A legal update from Dechert LLP

U.S. Consumer Financial Protection Bureau Issues Rules on Qualified Mortgages and Ability to Repay

Congress in the Dodd-Frank Act responded to concerns about the quality of mortgage loans by establishing incentives for lenders to seek to ensure that borrowers had the ability to repay mortgage loans made to them. In response to a directive from Congress, the Consumer Financial Protection Bureau (the “Bureau”) has issued its much anticipated Ability-to-Repay (“ATR”) Rule and Qualified Mortgage (“QM”) Rule (the “Rules”), which will go into effect on January 14, 2014. The following is a brief overview of the new Rules.

The Ability-to-Repay Rule

The key to the Rules is the ATR requirement, which will require a lender to make a reasonable and good faith determination that a consumer has a reasonable ability to repay a loan in accordance with its terms. Any lender that fails to satisfy the ATR rule will be at risk for the following penalties and liabilities:

1. general Truth in Lending Act damages,
2. special ATR statutory damages, and
3. in a foreclosure action, a defense by recoupment or setoff.

The Structure of the New Ability-to-Repay World

Under the structure provided by the Bureau’s Rules, there will be three categories of loans.

QM Safe Harbor Loans. The first category will be those QMs that qualify for a safe harbor from the penalties and liabilities described above. These are first lien loans on a borrower’s principal dwelling which have an interest rate of less than 1.5% (or 3.5% for subordinate lien loans) higher than the average prime offer rate available in the vicinity (“Prime Loans”) and which meet the QM requirements. Such loans would be subject to a safe harbor and deemed to comply with the ATR requirements.

QM Rebuttable Presumption Loans. The second category will be those QMs that qualify for a rebuttable presumption of compliance as protection from the same penalties and liabilities described above. These are first lien loans on a borrower’s principal dwelling which have an interest rate equal or greater than 1.5% (or 3.5% for subordinate lien loans) above the average prime offer rate available in the vicinity (“Higher-Priced Loans”) and which meet the QM requirements. Such loans would be subject to a rebuttable presumption that the lender satisfied the ATR requirements.

Non-QM Loans. The final category will be all loans which are not QMs. These loans must comply with the ATR requirements. The Rules do not create legal protections for lenders in regards to this category of loans.

The Legal Difference Between a Safe Harbor and a Rebuttable Presumption

When a loan qualifies for the safe harbor, if the lender is sued by a borrower for failure to comply with the applicable requirements, as long as the lender can successfully show that the loan is a QM, the lender would be subject to a safe harbor and deemed to comply with the ATR requirements.

If a loan only qualifies for a rebuttable presumption, the borrower would be able to present evidence to challenge the lender's determination that the borrower satisfied the ATR requirement at the time of origination.

Specifically, to overcome the rebuttable presumption, a borrower must prove that, despite meeting the QM requirements, the lender did not make a reasonable and good faith determination of the borrower's ability to repay at the time of consummation, by showing that the borrower's income, debt obligations, alimony, child support and the borrower's monthly payment (including mortgage-related obligations) on the loan and on any simultaneous loans of which the lender was aware would leave the borrower with insufficient residual income or assets other than the value of the dwelling (including any real property attached to the dwelling) that secures the loan with which to meet living expenses, including any recurring and material non-debt obligations of which the lender was aware at the time of consummation.

The Bureau did not define living expenses or recurring and material non-debt obligations, but wrote in its commentary that these might include costs such as food, clothing, gasoline and health care, including the payment of recurring medical expenses. The lack of clear definitions may mean that lenders will want to conduct expanded diligence on a borrower's personal monthly expenses as part of their ATR processes.

A Qualified Mortgage

To meet the definition of a QM, a loan must not contain certain features, including:

1. excessive upfront points and fees (those exceeding 3% of the total loan amount, less "bona fide discount points" for prime loans),
2. interest-only payments,
3. negative-amortization, and
4. terms of longer than 30 years.

Additionally, in order to qualify as a QM, a loan must be made to a borrower whose total monthly debt-to-income ratio does not exceed 43%. To qualify as a QM, lenders must also verify and document the income and financial resources relied upon to qualify the borrower on the loan and underwrite the loan based on a fully amortizing payment schedule and maximum interest rate during the first five years, taking into account all applicable taxes, insurance and assessments.

Application of QM Rule to GSE-Eligible Loans

To ease the effect of this new rule and encourage the continued recovery of the mortgage market, loans that do not meet the 43% debt-to-income ratio, but that do meet other government-related loan standards, including loans which are eligible to be purchased by Fannie Mae and Freddie Mac (provided that they remain in conservatorship), the Department of Housing and Urban Development, the Department of Veterans Affairs, the Department of Agriculture or the Rural Housing Service will also be considered QMs. This temporary provision will phase out over time as the various agencies issue their own QM rules and if GSE conservatorship ends, and in any event after 7 years (ending January 10, 2021). Just as is the case with QMs that meet the standard requirements of the QM Rule, these loans will either provide lenders with a safe harbor or a rebuttable presumption based on whether they are Prime Loans or Higher-Priced Loans.

Ability to Repay Standards

In order to meet the ATR requirements, a lender must consider and verify eight underwriting standards for the borrower, consisting of:

1. current or reasonably expected income or assets,
2. current employment status,
3. the monthly payment on the covered transaction,
4. the monthly payment on any simultaneous loan,
5. the monthly payment for mortgage-related obligations (such as property taxes),
6. current debt obligations, alimony and child support,
7. the monthly debt-to-income ratio or residual income, and
8. credit history.

The Practical Impact on the Market

Although the QM definition includes a broad spectrum of loans, there will likely be a significant preference among lenders and loan purchasers for QM loans which qualify for the safe harbor.

Lenders may be reluctant to make QMs that will only provide a rebuttable presumption or non-QM loans. As a result, there could be contraction and realignment in the mortgage market for non-prime borrowers. This may disproportionately affect low-income populations and certain geographic areas, raising questions as to whether government regulations are incentivizing lending standards that have a disparate impact, which, in turn, may generate fair lending challenges by the government and private parties and performance evaluation issues under the Community Reinvestment Act.

Another potential impact may be seen in the ability to securitize loans. Safe harbor QMs will be more predictable and thus may be more easily securitized. Securitization may be more complicated for QMs with a rebuttable presumption, as the resulting loans will be less homogeneous, the loans will be more likely to face legal challenges for the first few years, and the market may have less appetite for the product.

The Bureau estimates that based on 2011 data (without temporary government-related purchase QM treatment) 76% of mortgages would have been QM safe harbor loans, 2% of mortgages would have been QM rebuttable presumption loans and 22% of mortgages would have been non-QM loans. Taking account of, among other things, existing regulations regarding Higher-Priced Loans, the Bureau states that in the current marketplace, it anticipates that the impact of the Rules on access to credit will be very small. The Bureau further observes that to the extent that the Rules reduce credit access, the Rules will primarily reduce lending that ignores or inappropriately discounts a consumer's ability to repay a loan, rather than impeding access to credit for borrowers who have the ability to repay.

Additional Proposed QM Rule

The Bureau has also released a proposal to amend the Rules to provide QM status to certain loans made and held in portfolio by small creditors, and to exempt certain nonprofit creditors and certain homeownership stabilization programs from the requirements contained in the Rules. The comment period on this proposal is open through February 25, 2013.

Dechert LLP to Host QM Rule Webinar
Dechert will host a live webinar on Wednesday, January 23 from 12:00 -1:00 PM Eastern focusing on the legal and practical impacts these important developments will have on lenders, borrowers, loan purchasers and securitizers. Please click here to register for this webinar, "A New World for Mortgage Lending: CFPB Issues Qualified Mortgage Rule."

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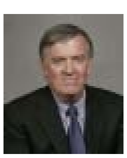
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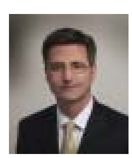
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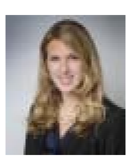
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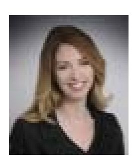
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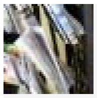

For more information on Dechert's Finance and Real Estate Group, click here; for Dechert's Financial Services Group, click here.

See our Dodd-Frank reference materials for up to date analysis and regulatory actions.