Client Alert.

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CFPB Ability to Repay Rules Issued

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SUMMARY

On January 10, 2013, the Consumer Financial Protection Bureau issued much-anticipated revisions to Regulation Z to implement provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act that require lenders to make a reasonable good faith determination that borrowers have the ability to repay their mortgage loans. The final rule ("ATR Rule") continues a process that began with a May 2011 proposal from the Federal Reserve Board and is effective for applications received on or after January 10, 2014. But, we're not done yet. Along with the ATR Rule, the CFPB issued proposed changes to it dealing with balloon payments, points and fees calculations, and other possible revisions.

At first blush, the ATR Rule might seem straightforward. Mortgage lenders must make an ability to repay determination by verifying and evaluating a list of traditional indicia of creditworthiness. They obtain a compliance safe harbor or a rebuttable presumption of compliance (depending on the loan's annual percentage rate) if they originate a Qualified Mortgage ("QM"). QMs are regularly amortizing loans, underwritten to standard rules and assumptions, that carry no more than a prescribed number of points and fees (3% of the "total loan amount" for loans of $100,000 or more) and a maximum 43% total debt-to-income (DTI) ratio. The 43% DTI limit does not apply, for a limited time, if a QM loan could be sold to Fannie Mae or Freddie Mac, or guaranteed or insured by a federal agency. In addition, some of the rules don't apply when certain "non-standard" mortgages are refinanced into safer "standard" mortgages.

As it's often said, however, "the devil is in the details" and there are a lot of details in the 800+ page Federal Register notice. The rules contain extensive provisions governing the many elements in the points and fees calculation. Other provisions specify what rates, payments, and loan balances should be used for underwriting ARM's, interest-only, balloon and negatively-amortizing loans. Still others indicate what debts and other obligations need to be considered in underwriting analyses and DTI calculations and what factors must be independently verified (most, and especially income and employment), and how the verification may occur. Given that the rule essentially establishes a federal law of mortgage underwriting procedures, Regulation Z now has a new Appendix Q sporting a set of HUD-based underwriting guidelines that dictate—in numbing detail—how a Regulation Z DTI should be calculated (Tip: rent from boarders may be income; rent from roommates probably isn't.)

The ATR Rule presents significant compliance challenges and litigation risks. The points and fees test is quite complex—over sixty pages in the notice discuss the definition of "points and fees"—and the failure to apply the test correctly could disqualify a creditor from whatever protection is afforded under the QM safe harbor or compliance presumption. Points and fees include originator compensation along with fees paid to affiliates. Including originator compensation requires the measurement and incorporation of a value that has not traditionally been a part of compliance calculations. The Bureau's rule contained few kind words about affiliated business arrangements and including affiliate charges in points and fees could rapidly eat away at the 3 percentage point threshold, thus disqualifying loans involving affiliate services from QM status. And then there is the new Appendix

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Q. Regulation Z has always had appendices—D and J, for example—that are not for civilians. Appendix Q, however, may set new standards for complexity and regulatory pitfalls. Failure to follow its provisions to the letter could subject creditors to significant liability, and it is not clear that certain requirements are even remotely practical in the real world (*i.e.,* when analyzing the probability of continued employment, considering a consumer's qualifications for a position and their previous training and education).

Finally, one must consider how safe the safe harbor actually will be. There was much debate during the rulemaking over what compliance presumptions—either a conclusive "safe harbor" or a rebuttable presumption of compliance—would emerge for QMs. Now we know that the answer is "both." This means that a mortgage can be (i) a safe harbor QM because it meets the full QM definition (limited to loans with a DTI or 43% or less); (ii) a safe harbor QM because it meets more limited criteria but is agency-eligible; (iii) a QM with a rebuttable presumption of compliance but not a safe harbor; or (iv) a plain old mortgage loan that, all by itself, must meet the ability to repay requirement unassisted by any presumptions. Along this continuum, the term "safe harbor" suggests a place of relative calm in a liability storm. Nevertheless, creditors may have to fight to establish that the transaction is a QM in the first place. This could be a significant fight in its own right, and while it may be a different fight than the one faced absent a "safe harbor" or rebuttable presumption, it is one many creditors may choose not to have if it must take place in front of a jury. And if it is a fight that won't be fought, maybe there isn't significantly more value, as a practical matter, in a "safe harbor." Only time will tell.

The principal features of the ATR Rule are summarized below. In addition, the market will also be strongly influenced by an associated rulemaking related to Qualified Residential Mortgages ("QRMs") and proposed bank capital requirements that encompass mortgage lending. Under the QRM provisions, lenders will have to retain risk or have "skin in the game" on transactions that are not QRMs. Under the proposed capital rules, known as the Standardized Approach, certain categories of loans receive favorable capital treatment compared to others. In combination, the ATR Rule, the yet-to-be-issued QRM rules, and the Standardized Approach proposal present a fluid mixture of risk and cost considerations that will greatly influence the future of the mortgage market. We therefore close with a brief discussion of QRMs and the Standardized Approach.

ATR RULE COVERAGE AND GENERAL REQUIREMENTS

The ATR Rule applies to consumer purpose credit transactions secured by a dwelling. The dwelling need not be a principal dwelling or real property. Purchase transactions and refinancing are covered and lien priority is irrelevant. The rules do not apply, however, to home equity lines of credit, loans secured by timeshare interests, reverse mortgages, or bridge and construction loans with terms of 12 months or less.

Under the general rule, a creditor may not make a covered loan unless it 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." This determination must consider the following factors:

- Current or reasonably expected income or assets
- Employment status
- Monthly payment on the transaction
- Monthly payments on simultaneous loans
- Monthly payment for mortgage-related obligations (such as property taxes)

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- Debt obligations, alimony, and child support
- Debt-to-income ratio or residual income
- Credit history

The creditor must verify information using “reasonably reliable third-party records” and the rule provides a roadmap for the verification of income, employment, and debts. Thus, stated-income (remember those?) or similar no-doc loans are not permitted under the rule. In addition, the rule provides detailed guidance on how loan payments are to be evaluated (i.e., for ARMs, interest-only, negatively amortizing, and balloon loans) and how DTI calculations must be performed.

The CFPB stressed that the ATR Rule is not intended to require creditors to use a specific government underwriting standard or to preclude the use or development of proprietary models. The ATR Rule mandates that the factors noted above be considered but not what conclusion they must yield. Rather, consistent with the subjectivity inherent in “good faith” and “reasonableness” standards, many other factors will be relevant in ascertaining whether the ability to repay determination was proper. For example, the fact that a consumer made a significant number of timely payments, that time-tested underwriting standards were used, or that the models were empirically derived and statistically sound were used suggest a reasonable good faith determination. By contrast, an early payment default, use of guidelines that have historically led to higher defaults, or the use of inconsistent standards or exceptions suggest the opposite. An adverse change in circumstances after consummation that cannot be reasonably anticipated should not undercut the creditor’s good faith determination. On the other hand, a predictable change that is not incorporated into the underwriting analysis could be problematic. It is an open question as to how omniscient creditors will have to be to satisfy this standard.

COMPLIANCE SAFE HARBOR OR PRESUMPTION

There are significant penalties for failure to meet the ATR requirements. In addition to the ordinary TILA remedies, a consumer may recover all finance charges and fees paid on the transaction unless it can be established that the failure to comply was not material. Consumers have three years (rather than the normal one year TILA statute of limitations) to bring suits alleging violations of these rules and violations may always be raised by consumers as a defense in foreclosure proceedings. The industry argued that without some level of compliance certainty, mortgage credit would dry up since lenders and loan purchasers or securitizers would refuse to subject themselves to such draconian liability for making or acquiring mortgage loans. The Federal Reserve Board requested comment on either a compliance safe harbor or a rebuttable presumption of compliance. The final ATR Rule has both.

Using price as a crude barometer, the rule is designed to afford greater legal protection to creditors that originate prime versus non-prime loans. Under the safe harbor provision in the final rule, a creditor or assignee of a “qualified mortgage” that is *not* a “higher-priced” transaction is deemed to comply with the ability to repay requirements. A “higher-priced” transaction is one in where the APR exceeds the average prime offer rate (“APOR”) by 1.5 percentage points or more for a first-lien loan or 3.5 percentage points or more for a subordinate lien loan. Higher priced QMs are entitled to a rebuttable presumption of compliance, rather than a safe harbor.

A consumer may rebut the compliance presumption on higher-priced loans by showing that the consumer’s income and obligations would leave them with insufficient residual income or assets to meet living expenses including “any recurring and material non-debt obligations of which the creditor was aware at the time of

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consummation." Unfortunately, the rule does not include guidance on what would constitute sufficient residual income. This could be an issue fraught with risk. What is a sufficient residual income will no doubt depend on several factors, such as the number of dependents a borrower has, and the cost of living for the area where the borrower lives.

QUALIFIED MORTGAGES

There are 3 paths to QM status—a general definition, a temporary alternative definition for loans eligible to be purchased, insured or guaranteed by specified federal instrumentalities (such as Fannie/Freddie, FHA or VA), and finally one covering certain balloon loans by small rural creditors.

General QM Definition

Under the general definition, a QM must meet the following requirements:

1. Except for ARM's and step-rate mortgages, the loan must provide for regular, substantially equal periodic payments. Negatively amortizing loans, subject to very limited exceptions, balloon loans, or those permitting the deferral of principal do not meet the definition.
2. The loan term may not exceed 30 years.
3. The total "points and fees" on the loan do not exceed the following thresholds:
    a. 3% of the "total loan amount" for loans $100,000 or greater;
    b. $3,000 for loans less than $100,000 but $60,000 or greater;
    c. 5% of the total loan amount for loans less than $60,000 but $20,000 or greater
    d. $1,000 for loans less than $20,000 but $12,500 or greater; and
    e. 8% of the total loan amount for loans of less than $12,500.
4. The creditor's underwriting factors in payments based on the highest rate that may apply in the first 5 years.
5. The creditor evaluates income, debts, and other obligations in accordance with prescribed guidelines in the new Appendix Q.
6. The total-DTI (again, based on Appendix Q) does not exceed 43%.

Points and Fees

Points and fees tests now abound in Regulation Z and the same definitions are used to determine HOEPA coverage and the QM limitation. A fee that is "known at or before consummation"—not just paid before consummation—can meet the definition. The following costs are included:

1. All items in the finance charge under sections 4(a) and 4(b) of Regulation Z except that:
    a. Interest is not included.

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   b. Federal and state mortgage guarantee or insurance premiums are not included.

   c. Post-closing PMI premiums are excluded. Pre-closing PMI not in excess of FHA insurance premiums may also be excluded in certain cases.

   d. "Bona fide discount points" may be excluded—up to 2 points for loans where the undiscounted rate does not exceed the APOR by more than 1 percentage point; up to 1 point where the undiscounted rate does not exceed the APOR by more than 2 percentage points.

2. Loan originator compensation that can be attributed to the transaction at the time the rate is set.

3. Real estate-related fees (that are not finance charges under Regulation Z section 4(c)(7)) unless the fees are reasonable, the creditor receives no direct or indirect compensation from the fee, and the fee is not paid to an affiliate.

4. Up-front credit life, disability, unemployment, or property insurance or debt cancellation agreements.

5. Certain prepayment penalties that would be payable under the new loan.

6. Prepayment penalties on a loan being refinanced if the refinancing is with a holder or servicer of the old loan.

Several observations are in order. As noted earlier, while discount points are finance charges, a prescribed number of "bona fide" discount points are not counted in the points and fees calculation. Bona fide discount points are those that reduce the interest rate "based on a calculation that is consistent with established industry practices." The inclusion of originator compensation is a significant development—it may dramatically shrink the "headroom" available under the points and fees test. Finally, while affiliate charges have always been included for HOEPA purposes, they become much more significant given the lower points and fees threshold in the QM definition.

Alternative QM Tests

The ATR Rule contains several alternative definitions of a QM. Under the most significant, loans that are eligible to be purchased or guaranteed by Fannie or Freddie (or a limited life successor to either), or eligible to be insured or guaranteed by HUD, VA, the Department of Agriculture or the Rural Housing Service need only meet the first 3 elements (regular amortizing payments, no more than 30 year term, points and fees test) of the general QM definition to qualify as QMs. This is significant because it removes not only the 43% DTI limitation but also the need to evaluate the transaction under the detailed underwriting provisions in Appendix Q of Regulation Z (although this still may be prudent from a belt and suspenders perspective). This special rule expires on January 10, 2021 for Fannie Mae or Freddie Mac (or sooner if they exit conservatorship/receivership before that date or sooner for the FHA/VA/Agriculture/Rural Housing agencies if those agencies establish their own QM definition. The rule also means that jumbo loans (that are not eligible for purchase by Fannie Mae or Freddie Mac or government insurance or guarantee) that have a DTI greater than 43% cannot be QMs, and must be made under the basic ability-to-repay rule. Such loans therefore do not have the safe harbor, or even the rebuttable presumption provisions that apply to QM loans. How this will impact the pricing of such loans, access by consumer to such products, and development of a vibrant "private" secondary market remains to be seen.

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CONCURRENT PROPOSAL

On January 10, 2013, along with the ATR Rule, the CFPB issued a proposed rule that would amend the ATR Rule. The proposed rule would clarify the treatment of originator compensation for purposes of the points and fees test. In addition, the proposal would:

- Exempt state housing finance agencies and non-profit creditors that provide low- and moderate-income consumers that provide mortgage loans;
- Exempt certain homeownership stabilization programs (state and federal) that provide mortgage loans to consumers that may be facing foreclosure;
- Exempt certain refinancing programs offered by Fannie Mae and Freddie Mac; and
- Exempt from the 43% DTI standard, loans originated and held in portfolio by “small” lenders (those with assets of $2 billion or less, and that originate 500 or fewer first lien mortgage loans.

The comment period on the proposal ends February 25, 2013.

QRM AND BASEL III

In the wake of the financial crisis, certain types of transactions—to the extent they still exist in the marketplace—are under attack on multiple fronts. The ATR Rule is one of 3 regulatory schemes that attempt to define categories of mortgage loans that are favored either through reduced regulatory risk or reduced cost to originate or hold. In theory, QMs present reduced regulatory risk. Closely related, however, are the cost-favored categories of loans—Qualified Residential Mortgages under Dodd-Frank and “Category 1” mortgage loans under the proposed Standardized Approach capital rules.

The Dodd-Frank Act generally requires securitizers of asset-backed securities to retain 5% of the credit risk of the assets collateralizing the ABS. In April 2011, the Federal Reserve Board, OCC, FDIC, SEC, FHFA, and HUD proposed rules implementing the statute. In general, the statute and proposed rules provide that the risk retention provisions do not apply to QRMs. The agencies must define QRM, taking into account underwriting and product features that loan performance data indicate result in a lower risk of default.

The statute provides that the definition of QRM shall not be broader than the definition of QM that has now been finalized in the ATR Rule. Thus, in addition to any heightened regulatory risk of not receiving the compliance safe harbor or rebuttable presumption, credit risk will have to be retained for non-QM mortgages. Further, the agencies may, consistent with the provisions of the statute, require the retention of credit risk for some QMs. The agencies have not yet issued final QRM rules.

The proposed Standardized Approach capital rule presents a third way of looking at residential mortgage loans, which will complicate the lives of most banks that make mortgage loans. Of course, the Standardized Approach has a different focus, credit risk, from that of the ATR Rule, consumer protection. The Standardized Approach proposal divides mortgage loans into two categories, with Category 1 receiving more favorable capital treatment. The criteria for Category 1 overlap with those for QM status, but it is entirely possible that a loan could qualify as a Category 1 loan, yet not as a QM and even vice versa. For example, a QM must comply with limits on points and fees, while Category 1 does not impose any such limits. Similarly, while the underwriting standards for a Category 1 loan include a determination of the borrower’s ability to repay, the Category 1 criteria do not include the specific 43% DTI ratio. On the other hand, interest-only and negative amortization loans that meet certain

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qualifications can qualify as QMs; these are excluded entirely from Category 1. The federal banking agencies have been silent as to whether or how Category 1 standards might be aligned with those for QM or QRM.

CONCLUSION

The new ATR Rule will present a number of compliance challenges and could strongly influence what types of mortgage products will be offered in the future. This is not an accident—a number of overlapping regulatory requirements are designed to make the world unsafe and costly for certain disfavored products. Many commenters on the proposed rule urged the CFPB to adopt "bright-line" rules so that lenders can know what steps they must take to comply with the provisions. While there are many "lines" in the rule (approximately 16,000), those lines are sometimes not so bright. The lack of bright lines creates uncertainty, which often means greater litigation risks, costs to consumers, and diminished access to credit.

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