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CFPB issues ability-to-repay and qualified mortgage rules

By Raymond J. Gustini, Lloyd H. Spencer, Tiana M. Butcher, Courtney L. Lindsay II, and Pierce Han

"No standard is perfect, but this standard draws a clear line that will provide a real measure of protection to borrowers and increased certainty to the mortgage market..."
CFPB Director Richard Cordray

The Consumer Financial Protection Bureau ("CFPB") has issued one of several major rules mandated by the Dodd-Frank Act that will have a significant impact on the U.S. mortgage market. The rule, issued on January 10, 2013, addresses the ability-to-repay requirements and qualified mortgage standards contained in the 2010 Dodd-Frank Act. The final release, some 800 pages in length, set requirements for how mortgage lenders can demonstrate that they have effectively considered the consumer's ability to repay a mortgage loan. In addition, the rule clarifies when a mortgage may be classified as a "qualified mortgage" and when a lender is eligible for a safe harbor or a presumption that the lender has complied with the ability-to-repay requirements. The rule clarifies that when a mortgage lender makes a prime qualified mortgage, the lender will be conclusively presumed to have complied with the ability-to-repay rule, which will, in effect, provide the lender with a safe harbor. In contrast, when a mortgage lender makes a higher-priced qualified mortgage, the lender will be presumed to have complied with the ability-to-repay rule but the presumption will be rebuttable and not conclusive. With higher-priced loans, borrowers may challenge the presumption if they effectively bring a claim that the lender did not adequately consider the borrower's ability to repay. Lenders may still offer mortgages that do not fall within the definition of a "qualified mortgage." However, the lender will not be eligible for any presumption of compliance and the burden of demonstrating compliance rests with the lender.

Background

The CFPB rule expands and modifies the 2008 rule published by the Federal Reserve Board under Regulation Z that prohibited lenders from making "higher-priced" mortgage loans without assessing the consumer's ability to repay. The 2008 rule only covered higher-priced loans. The CFPB rule, as required by Dodd-Frank, covers all mortgage loans (except open-end credit plans, timeshare plans, reverse mortgages, or temporary loans) and also provides clarity on what constitutes a qualified mortgage. In its release, the CFPB appears to have succeeded in balancing the interests of consumers in robust protection from predatory mortgage products while also addressing the concerns of lenders that the rules not adversely impact the fragile recovery of the U.S. mortgage market.

The recognition of the CFPB that the rule should be balanced is evident in light of the detailed information provided in the preamble to the rule on the tightened credit standards currently prevailing in the U.S. mortgage market. The CFPB noted that for consumers with low or lower credit scores or without the resources for large down payments, mortgage credit has been difficult to obtain and that credit standards have been raised significantly. For example, in 2012, according to CFPB, the average FICO score for a mortgage was 750, the average loan-to-value ratio was 78%, and the debt-to-income ratio was 34.5%. By contrast, in 2007 at the peak of the housing bubble, the average FICO score was 706, LTV was 80%, and DTI was 39.8%.

The ability-to-repay rule is also just one of several rules impacting the U.S. mortgage market that were released by the CFPB in recent weeks. These include rules on escrows, loan servicing, HOEPA (Home Ownership and Equity Protection Act), loan originator compensation, and appraisals. Further, the bank regulatory agencies and several other agencies are also tasked with issuing rules on risk retention for securitizers of asset-backed securities, including mortgages. Accordingly, the ability-to-repay rule and the rules that followed are significant steps in what may be the transformation of the vast U.S. mortgage market as a result of Dodd-Frank. The ability-to-repay rule takes effect on January 10, 2014, and is discussed in detail below.

Discussion of the ability-to-repay qualified mortgage rule

The rule contains the following significant features:

- The eight minimum requirements for creditors making ability-to-repay determinations;
- The records a lender should evaluate when determining a borrower's ability-to-repay;
- The requirements for qualified mortgages and the way in which qualified mortgages and certain underwriting standards achieve a conclusive presumption ("safe harbor") that the lender has complied with the ability-to-repay rule;
- A temporary category of qualified mortgages provided that they satisfy Fannie Mae and Freddie Mac underwriting requirements;
- An exemption from the ability-to-repay requirements when refinancing non-standard mortgages;
- Limitations on prepayment penalties; and
- Additional CFPB final and proposed regulations.

CFPB ability-to-repay determination

Under the new CFPB ability-to-repay regulations, mortgage lenders will be required to consider eight underwriting factors: (1) current or reasonably expected income or assets; (2) current employment status; (3) monthly payment on the current transaction; (4) the monthly payment on any simultaneous loan; (5) the monthly payment for mortgage-related obligations; (6) current debt obligations, alimony, and child support; (7) the monthly debt-to-income ratio or residual income; and (8) credit history. With respect to adjustable rate mortgages, the monthly payment is required to be calculated using the higher of a fully indexed rate or an introductory rate.

Lenders are also required to preserve for three years after the completion of a covered mortgage transaction, all records used to verify a borrower's ability to repay.

A borrower that successfully brings an action against a lender for violating the ability-to-repay requirements may be able to recover special statutory damages under the Truth in Lending Act that are equal to the cost of all finance fees and charges paid by the borrower. This is in addition to any other fees and damages that may be available.

Qualified mortgages

When mortgage credit is extended for "qualified mortgages," lenders are eligible for significant protection under the ability-to-repay rule. The final rule established three categories of qualified mortgages (i) general qualified mortgages, (ii) balloon payment qualified mortgages made by certain lenders, and (iii) transitional qualified mortgages. Qualified mortgages that *are not* higher-priced mortgages are subject to a conclusive presumption or "safe harbor" against claims that the lender failed to adequately evaluate a borrower's ability-to-repay. Qualified mortgages that *are* higher-priced loans are subject to a rebuttable presumption that the lender satisfied the ability-to-repay requirement. Higher-priced loans are loans with an annual percentage rate that exceeds the average prime offer rate for a comparable transaction, as of the date the interest rate is set, by 1.5% or more for a first-lien covered transaction or by 3.5% or more for a subordinate-lien covered transaction.

The Dodd-Frank Act described qualified mortgages as follows:

- No loans with significant changes to periodic payments,
- No interest-only loans,
- No negative amortization loans,
- No loans over 30 years,
- No balloon payments (except for loans made by small lenders in rural areas),
- No "no doc" loans, and
- No loans where points and fees exceed 3% of the loan amount with an exception for "bona fide" discount points.

The rule also supplements the qualified mortgage definition contained in Dodd-Frank with certain underwriting standards including that monthly payments be calculated based on the highest payment in the first five years and a debt-to-income ratio equal to or less than 43%. The CFPB also created a temporary exception to the qualified mortgage definition for mortgages with debt-to-income ratios above 43% if such loans satisfy the general product features of a qualified mortgage, but also satisfy underwriting criteria of the GSEs (i.e., Fannie Mae and Freddie Mac while they operate in a federal conservatorship) or the FHA, VA, or the USDA or Rural Housing Service.

This temporary category will expire in its entirety on January 10, 2021.

Refinancing non-standard mortgage exemption

The CFPB regulations provide an exemption from the ability-to-repay lending standards when the lender is refinancing a "non-standard" mortgage into a standard mortgage. Non-standard mortgages include adjustable rate mortgages, interest only mortgages, and those mortgages with a negative amortization schedule. A standard mortgage is one with relatively stable payments and other traditional characteristics.

This exemption to the ability-to-repay rule will only apply, however, if:

- The lender for the standard mortgage is the current holder of the existing non-standard mortgage or is the servicer acting on behalf of the current holder;
- The monthly payment for the refinanced, standard mortgage is materially lower than the monthly payment for the non-standard mortgage;
- The lender receives the consumer's written application for the standard mortgage no later than two months after the non-standard mortgage terms recast;
- The borrower made *no more than one* payment that is more than 30 days late on the non-standard mortgage during the 12 months immediately preceding the refinancing lender's receipt of the application for the standard mortgage;
- The borrower made *no* payments more than 30 days late during the 6 months preceding the refinancing lender's receipt of the borrower's application for the standard mortgage;
- If the non-standard mortgage is made on or after January 10, 2014, the lender complied with the ability-to-repay rules; and
- The lender has considered whether the standard mortgage likely will prevent a default by the consumer on the non-standard mortgage once recast.

Limitations on prepayment penalties

The CFPB rules also include limitations on when a lender may charge a borrower for paying all or part of the principal amount of the loan before it becomes due. The rule generally limits a lender from charging prepayment penalties on higher-priced loans and non-qualified mortgages. The fee cannot apply after the third anniversary of the date of the loan and cannot exceed (a) 2% if incurred within the first two years of the loan or (b) 1% if incurred during the third year of the loan. The rule also requires that, if a lender offers a borrower a loan with a prepayment penalty, it must also offer the borrower an alternative without a prepayment penalty that meets certain other specified criteria.

Looking forward

The CFPB has also invited comment on a few other proposals that have yet to be finalized. One of the issues that the CFPB may address in a future release is whether there should be different standards for lending organizations that serve rural or underserved communities. The CFPB is specifically looking for comment on whether nonprofit organizations, homeownership stabilization programs, federal agencies, and government sponsored entities should be exempt from the ability-to-repay requirement. The CFPB also invited comment on whether safe harbor or rebuttable presumption provisions should be modified for smaller lenders. The CFPB intends to finalize the proposal in spring 2013 with the intent that it become effective in January 2014.

Lenders should also be aware of other final rules recently issued by the CFPB. These include rules: (1) implementing Dodd-Frank provisions requiring escrow accounts for higher-priced mortgage loans (January 10); (2) expanding protections for "high-cost mortgages" under the Homeownership and Equity Protection Act and implementing requirements concerning homeownership counseling (January 10); (3) implementing Dodd-Frank requirements regarding force-placed insurance, error resolution, information requests, payment crediting, and periodic mortgage loan statements and adjustable-rate mortgage reset disclosures as well as finalizing rules on early intervention for troubled and delinquent customers and loss mitigation procedures (January 17); (4) implementing Dodd-Frank requirements concerning appraisals (January 18); and (5) implementing Dodd-Frank rules relating to loan originator compensation and qualifications (January 20). Readers are encouraged to monitor alerts from Nixon Peabody, LLP for details about these rules.

For further information, please contact your regular Nixon Peabody attorney or:

- Raymond J. Gustini, 202-585-8725 or rgustini@nixonpeabody.com
- Lloyd H. Spencer, 202-585-8303 or lspencer@nixonpeabody.com
- Tiana M. Butcher, 202-585-8359 or tbutcher@nixonpeabody.com
- Courtney L. Lindsay II, 202-585-8742 or clindsay@nixonpeabody.com
- Pierce Han, 202-585-8139 or phan@nixonpeabody.com