Mortgage Reform Update: CFPB Issues Final Rule on Residential Mortgage Lending Requirements

January 29, 2013

Earlier this month, the Consumer Financial Protection Bureau ("CFPB") issued a final rule that prohibits all creditors (and not just banks) from making residential mortgage loans without regard to a borrower's repayment ability and subjects noncompliant creditors to unprecedented liability, including foregone interest on the loans they made. The final rule sets forth the specific income verification requirements, product features, and underwriting criteria—including a 43% debt-to-income ratio cap—that creditors must follow for residential mortgage loans to be treated as "qualified mortgages" and, therefore, subject to certain protections from liability.

The final rule, together with other mortgage rules, will redefine the primary and secondary residential mortgage markets for years to come. Steep liability for failure to appropriately establish repayment ability will encourage lenders to adhere to the rule's conservative standard for qualified mortgages. Moreover, defining the standard for a qualified mortgage was a necessary first step to defining what constitutes a "qualified residential mortgage" ("QRM"), which will be exempt from the 5% risk retention requirement for asset-backed securities.[1] As the preamble states, the final rule "will set the outer boundary of a QRM." Together, the qualified mortgage standard (discussed in detail below) and the QRM standard (the final version of which remains pending)[2] will dictate the types of residential mortgage loans that are made and sold in secondary markets and, ultimately, the size of the overall residential mortgage loan market.

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1 While the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") left it to the federal banking and housing agencies to define what constitutes a QRM, it mandated that the term be no broader than the "qualified mortgage" definition applied with respect to the ability-to-repay requirement. Yesterday, in a speech to the American Securitization Forum, Thomas J. Curry, the Comptroller of the Currency, said the final rule "helps pave the way" for another important rule under Dodd-Frank: the 5% risk retention requirement for asset-backed securities and the exemption from this requirement for QRMs. *See* Remarks of Thomas J. Curry, Comptroller of the Currency, American Securitization Forum, Las Vegas, Nevada, Jan. 28, 2013.

2 In addition to front- and back-end debt-to-income ratios, the QRM standard is expected to dictate underwriting criteria that are not part of the qualified mortgage standard, such as a minimum cash payment requirement and a loan-to-value requirement. For more information regarding the proposed risk retention rule, which remains pending, please see our memorandum, dated April 7, 2011, *available at* http://www.simpsonthacher.com/siteContent.cfm?contentID=4&itemID=75&focusID=1185.

The final rule, which is consistent in many respects with the proposed rule that was issued by the Federal Reserve in April 2011, [3] takes effect on January 10, 2014. As discussed below, the final rule provides temporary relief from the 43% debt-to-income ratio cap for certain loans made on or before January 10, 2021.

A. The Ability-to-Repay Requirement

The Truth in Lending Act, as amended by Dodd-Frank, prohibits a creditor from making a residential mortgage loan[4] unless the creditor makes a reasonable and good faith determination, based on verified and documented information, that, at the time the loan is consummated, the potential borrower has a reasonable ability to repay the loan according to its terms, including all applicable taxes, insurance, and assessments. Under the final rule, this requirement applies to secured residential mortgage loan transactions, but not to open-end credit plans (including home equity loans), timeshare plans, reverse mortgage loans, temporary or "bridge" loans with a term of 12 months or less, or the construction phase of 12 months or less of a construction-to-permanent loan.

1. Making the "Ability-to-Repay" Determination: Satisfaction of General Underwriting Standards and Payment Calculation Rules

While there are no limits on the features, term, points, or fees of a particular loan that a creditor may offer, creditors must satisfy general underwriting standards and payment calculation rules.

In making the ability-to-repay determination, a creditor must consider and verify (using reasonably reliable third party records, such as consumer credit reports, IRS tax transcripts and tax returns, financial institution records, and payroll statements) the following information pertaining to a potential borrower:

- current or reasonably expected income or assets (other than the value of the home that secures the loan);
- current employment status;

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3 On July 21, 2011, various rulemaking and other functions were transferred to the CFPB, including general rulemaking authority under the Truth in Lending Act.

4 Under the Truth in Lending Act, as amended by Dodd-Frank, a "residential mortgage loan" is broadly defined to include a dwelling-secured consumer credit transaction, regardless of whether the consumer credit transaction involves a home purchase, refinancing, home equity loan, first lien or subordinate lien, and regardless of whether the dwelling is a principal residence, second home, vacation home (other than a timeshare residence), a one-to-four unit residence, condominium, cooperative, mobile home, or manufactured home. For purposes of the ability-to-repay requirement, the CFPB rejected comments by an association of state banking regulators suggesting that the requirement be limited to owner-occupied primary residences. In the preamble to the final rule, the CFPB noted that vacation home loans can have marked effects on a consumer's finances and that an inability to pay a mortgage on such a home will likely have spillover effects on property values, potentially affecting other consumers.

- monthly payment on the mortgage loan;
- monthly payment on any simultaneous mortgage loan that the creditor knows or has reason to know will be made;
- monthly payment for mortgage-related obligations (*e.g.*, insurance, taxes, assessments);
- current debt obligations;
- monthly debt-to-income ratio, or residual income; and
- credit history.

In addition, a creditor must underwrite the mortgage loan payment according to certain assumptions and calculations. Specifically, the final rule requires a creditor to calculate the mortgage loan payment based on (i) the fully indexed rate or any introductory interest rate (whichever is greater); and (ii) monthly, substantially equal payments that fully amortize the loan amount over the loan term.[5] Special payment calculations apply in the case of interest-only loans, negative amortization loans, and loans with certain balloon payment features.

2. <u>Qualified Mortgages</u>

Dodd-Frank provides a presumption of compliance with the ability-to-repay requirement for creditors making "qualified mortgages." These are mortgages that meet certain product-feature prerequisites and are based on affordability-related underwriting requirements. However, because Dodd-Frank did not specify whether this presumption is conclusive or rebuttable, the final rule establishes a safe harbor for qualified mortgages that are lower-priced (prime) loans and a presumption of compliance for qualified mortgages that are higher-priced (subprime) loans.

(i) General Requirements for Qualified Mortgages

Below are the general requirements that must be met for a residential mortgage loan to be considered a "qualified mortgage":

- <u>*Elimination of Nontraditional Loan Features*</u>—The loan generally cannot have features such as negative amortization (where the principal amount increases), interest-only payments (where a borrower only pays the interest for a specified period of time so the principal does not decrease with payments), or balloon payments (where the payment is more than two times a regular periodic payment). The final rule provides a narrow

[5] Banks have been subject to substantially similar requirements since at least 2006, when the federal banking agencies issued interagency guidance on the need for banks to use the fully indexed rate and fully amortizing payment when qualifying consumers for loans with adjustable rates and potentially non-amortizing payments. *See* Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. 58609 (Oct. 4, 2006); *see also* Statement on Subprime Mortgage Lending, 72 Fed. Reg. 37569 (July 10, 2007).

exception for small creditors (*i.e.*, lenders originating 500 or fewer first-lien residential mortgage loans in the preceding calendar year with assets under $2 billion) operating predominantly in rural or undeserved areas to originate balloon-payment loans, but these loans must have a term of at least five years, a fixed-interest rate, and meet certain basic underwriting standards.

- *Maximum Loan Term*—The loan cannot have a term exceeding 30 years.
- *Limits on Points and Fees*—If the loan is for $100,000 or more, it cannot have points or fees greater than 3% of the total loan amount (stricter limits apply for smaller loans). However, certain "bona fide discount points" applicable to prime loans are excluded from the limits.
- *Income Verification and Monthly Debt-to-Income Ratio Cap*—Creditors must satisfy general underwriting criteria for the loan, including by verifying a potential borrower's current or reasonably expected income or assets (other than the value of the home securing the loan). The final rule also generally requires that monthly payments be calculated based on the highest payment that will apply in the first five years of the loan and that the borrower have a total "back-end" debt-to-income ratio no greater than 43%.

(ii) Safe Harbor Versus Rebuttable Presumption

The final rule distinguishes between two types of qualified mortgages, essentially based on whether the particular loan is prime or subprime.

For prime loans, which are typically given to low-risk borrowers with strong credit history, the final rule provides a safe harbor of compliance for creditors (and assignees of the loans). This type provides the greatest legal certainty that the creditor has made a good faith and reasonable determination of the borrower's ability to repay.

For subprime loans, which are typically given to more risky borrowers with insufficient or weak credit history and which are referred to in the final rule as "higher-priced mortgage loans" (*i.e.*, generally a consumer credit transaction secured by the borrower's principal dwelling with an annual percentage rate ("APR") 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 loans secured by a first lien on the dwelling, or by 3.5% or more for loans secured by a subordinate lien on the dwelling), there would be a rebuttable presumption of compliance with the ability-to-repay requirement.[6]

[6] Of course, many of the requirements of the final rule have applied to "higher-priced mortgage loans" since 2009, when regulations were adopted that (i) prohibited creditors from extending such loans with regard to a consumer's ability to repay; (ii) required creditors to verify income and assets that consumers rely upon to determine repayment ability; (iii) prohibited prepayment penalties except under certain circumstances; and (iv) required creditors to establish escrow accounts for taxes and insurance but permitted creditors to allow borrowers to cancel escrows 12 months after loan consummation. *See* 73 Fed. Reg. 444522 (July 30, 2008) (amending Regulation Z).

A borrower would be able to rebut this presumption by showing that, at the time the loan was originated, the borrower's income, debt obligations, alimony, child support, and monthly payment on the loan (and on any simultaneous loans of which the creditor was aware at consummation) left insufficient residual income or assets to meet living expenses. Guidance accompanying the final rule notes that the longer the period of time that the borrower has demonstrated an actual ability to repay the loan by making timely payments, without modification or accommodation, after consummation (or, for an adjustable-rate mortgage, after recast), the less likely the borrower will be able to rebut the presumption.

Although the final rule does not affect the rights of a borrower to challenge a creditor for violating any other federal consumer protection law, banks will be highly incentivized to originate residential mortgage loans that satisfy the qualified mortgage criteria because of the special legal protections afforded to them under the final rule.

(iii) Seven-Year Transitionary Relief for Certain Loans Consummated On or Before January 10, 2021

In light of the fragility of the current mortgage market, the CFPB's final rule provides temporary relief from the 43% debt-to-income ratio cap for loans that are eligible to be purchased or guaranteed by the Federal National Mortgage Association (Fannie Mae) or the Federal Home Loan Mortgage Corporation (Freddie Mac) (collectively, "GSEs"), are eligible to be insured by the U.S. Department of Housing and Urban Development or the Rural Housing Service, or are eligible to be guaranteed by the U.S. Department of Veteran Affairs or the U.S. Department of Agriculture. These loans, which would have to be consummated on or before January 10, 2021, could still be considered as qualified mortgages, provided that they also meet the requirements discussed above regarding the lack of toxic loan features, maximum 30-year loan term, and limits on points and fees.

3. Exemption for Refinancing Non-Standard Mortgages to Standard Mortgages

A creditor would be exempt from the ability-to-repay requirement if it:

- refinances a borrower from a "non-standard" mortgage with risky features to a so-called "standard" mortgage, which is a loan that has limits on loan fees and points; lacks features such as negative amortization, interest-only payments, or balloon payments; and is for a term of no longer than 40 years;
- considers whether the new standard mortgage will likely prevent a default by the borrower on the non-standard mortgage once the loan is reset and if the monthly payment for the standard mortgage is "materially lower" than what it is for the non-standard mortgage (according to CFPB guidance, this is a "facts and circumstances"-based analysis, but, in all cases, a payment reduction of 10% or more will meet this standard); and
- underwrites the standard mortgage based on an interest rate that is fixed for at least the first five years after consummation.

This exemption only applies if a creditor making the standard mortgage loan is also the holder of the non-standard mortgage or the servicer on behalf of the current holder. In addition, the creditor shall have received a borrower's written application for a standard mortgage no later than two months after the non-standard mortgage has recast and the borrower must not have had more than one late payment (by more than 30 days) on the non-standard mortgage during the 12 months immediately preceding the creditor's receipt of the application or any late payment (by more than 30 days) during the immediately preceding six months.

4. Creditor Liability for Non-Compliance

If a creditor violates the ability-to-repay requirement, a borrower would have the ability to recover damages consisting of the sum of all finance charges and fees paid by the borrower, although such damages could not be recovered if a creditor were to demonstrate that the failure to comply was not material. In addition to any finance charges and fees, a borrower would also be able to recover any actual damages, statutory damages in an individual action or class action (limited to no more than three years of finance charges and fees), and reasonable attorney's fees and court costs. While the statute of limitations for bringing a claim is three years from the date of the occurrence of the violation, a borrower may assert a violation by a creditor of the ability-to-repay requirement as a defense to foreclosure by recoupment or setoff at any time. Servicers should expect that borrowers in default will increasingly avail themselves of this defense, which will further increase the costs of foreclosures. Processes should be developed that allow a servicer to easily demonstrate that a loan was a "qualified mortgage" at origination or otherwise meets the ability-to-repay standard.

B. Other Features of the Final Rule

1. Limits on Prepayment Penalties

Consistent with the amendments to the Truth in Lending Act under Dodd-Frank, the final rule amends Regulation Z to provide that a secured residential mortgage loan transaction (excluding a home equity loan or timeshare plan) may not include a prepayment penalty unless the transaction: (i) has an APR that cannot increase after consummation (*i.e.*, a fixed or step-rate mortgage), (ii) is a qualified mortgage, and (iii) is not a higher-priced mortgage loan.

Assuming a loan meets the foregoing requirements, any prepayment penalty may only apply during the first three years following consummation of the transaction. For the first two years, the penalty may not exceed 2% of the outstanding loan balance, while a 1% cap will apply for the third year.

Furthermore, a creditor that offers to make a loan with a prepayment penalty is required to offer the potential borrower an alternative loan without such penalty. This alternative loan must be one for which the creditor has a good faith belief that the consumer likely qualifies.

2. Prohibition on Evasion through Open-End Credit Extensions

Currently, Regulation Z prohibits a creditor from structuring a closed-end loan as an open-end plan to evade the ability-to-repay requirement applicable to higher-priced mortgage loans. The final rule contains a similar provision in order to prevent evasion of the ability-to-repay requirement applicable to secured residential mortgage loans.

3. Lengthened Record Retention Obligations

Currently, Regulation Z requires creditors to retain evidence of compliance for two years after disclosures must be made or action must be taken. Because Dodd-Frank extends the statute of limitations for civil liability for a violation of the ability-to-repay or the prepayment penalty requirements to three years after the date of a violation, the final rule lengthens record retention with respect to the ability-to-repay or the prepayment penalty requirements to three years after the consummation of a transaction. In the preamble to the final rule, the CFPB stated that "responsible creditors" will likely retain records for a period of time "well beyond" three years.

C. Effectiveness

The final rule takes effect on January 10, 2014, which means that credit transactions for which a creditor receives an application on or after that date must comply with the ability-to-repay requirement and limits on prepayment penalties, as well as other features of the final rule. As discussed above, the final rule provides a seven-year transitionary period for creditors to provide qualified loans to borrowers that have total debt above 43% of monthly income if these loans otherwise satisfy the qualified mortgage criteria (*e.g.*, prohibitions on toxic loan features, limits on points and fees, and term length) and are eligible for purchase or guarantee by the GSEs or certain other federal agencies.

D. Proposed Modifications to the Final Rule

Concurrent with the release of the final rule, the CFPB issued a proposal to exempt designated non-profit lenders, homeownership stabilization plans, and certain refinancing programs by the GSEs and federal agencies from the ability-to-repay requirement. The proposal would also add a new category of qualified mortgages for all loans (and not simply those that have balloon-payment features as the final rule provides) that are originated and held on portfolio by small creditors.

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