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Uncertainty Regarding Fed Proposal – and CFPB Action – on Minimum Underwriting Standards for Consideration of a Consumer's Ability to Repay

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Comments are due in a month on a proposed rule ("Proposed Rule") issued by the Federal Reserve Board (the "Board") on a provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("DFA")[1] requiring mortgage lenders to take into account a borrower's ability to repay when making a mortgage loan. However, it remains unclear what the July 22, 2011 comment period close will mean for the Proposed Rule because, the day immediately preceding expiration of the comment period, jurisdiction of the Proposed Rule will shift to the new Consumer Financial Protection Bureau ("CFPB").

The DFA provision that is the subject of the Proposed Rule amends the Truth in Lending Act ("TILA")[2] by seeking to "assure that consumers are offered and receive residential mortgage loans on terms that reasonably reflect their ability to repay the loans."[3] The provision is a response to high mortgage delinquency and foreclosure rates during the financial crisis that prompted legislative and State Attorney General inquiries into certain creditors' practices in originating mortgage loans. A particular focus is the correlation between delinquency and foreclosure rates and practices in extending credit without regard to a consumer's ability to repay the loan. Pursuant to the DFA mandated reforms, the Board recently issued the Proposed Rule revising Regulation Z[4] to implement the TILA amendments.[5] Generally, the Proposed Rule would:

- require creditors to determine a consumer's ability to repay a mortgage before making a covered loan;
- establish minimum mortgage underwriting standards;
- limit prepayment penalties; and
- impose a record retention requirement on creditors to retain evidence of compliance with the rule.

Interestingly, the DFA's mortgage underwriting requirements are substantially similar although not identical to the ability-to-repay requirements adopted by the Board for higher-priced mortgage loans in July 2008 under the Home Ownership and Equity Protection Act. With the Board's general rulemaking authority for TILA scheduled to transfer to the CFPB on July 21, 2011, the Proposed Rule will not be finalized by the Board, but instead, by the CFPB. Accordingly, all comment letters will be

transferred to the CFPB and/or the CFPB may take such other action with respect to the Proposed Rule that it deems appropriate.

Overview

The central component of the Proposed Rule is a requirement that creditors determine a consumer's ability to repay before making a residential mortgage loan. For purposes of the requirement, a "residential mortgage loan" is defined as any consumer credit transaction secured by a dwelling, except for open-end credit plans (*e.g.*, a home equity line of credit or "HELOC"), timeshare plans, reverse mortgages, and temporary loans. The Proposed Rule provides four options for creditors to comply with the ability-to-repay requirement:

- A creditor can originate a mortgage loan under the general ability-to-repay standard by considering and verifying specified underwriting factors, such as the consumer's income or assets.
- A creditor can originate a "qualified mortgage" which, under two proposed alternative definitions, would operate either as a legal safe harbor or give rise to a presumption of compliance by the creditor that could be rebutted by the consumer.
- A qualifying creditor operating in a predominantly rural or underserved area can originate a balloon-payment qualified mortgage, which would preserve access to credit for consumers located in such areas.
- A creditor can meet the ability-to-repay requirement by refinancing a "nonstandard mortgage" into a "standard mortgage" with a lower monthly payment, which would help preserve access to streamlined refinancings.

As noted above, the ability-to-repay requirement does not apply to open-end credit plans secured by a dwelling, *e.g.*, HELOCs.[6] The Proposed Rule contains an anti-evasion provision that prohibits creditors from structuring a transaction that does not otherwise meet the definition of "open-end credit" for purposes of Regulation Z as a HELOC to avoid the repayment ability requirement for closed-end loans in the Proposed Rule.

Ability-to-Repay Requirement

Consistent with the requirements of Section 1411 of the DFA, the Proposed Rule provides that a creditor may not make a covered mortgage loan 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 consumer has a reasonable ability to repay the loan, including any mortgage-related obligations (such as property taxes and insurance).[7] The proposal includes four options for creditors to comply with the ability-to-repay requirement.

Option 1: General Ability to Repay Standard

Under the general ability-to-repay standard, there are no limits on the loan's features, term, or points and fees; however, the creditor must follow certain underwriting requirements and payment calculations. Specifically, a creditor relying on this option must consider and verify the following eight underwriting factors:

- Current or reasonably expected income or assets;
- Current employment status;

- The monthly payment on the loan;
- The monthly payment on any simultaneous loan;
- The monthly payment for mortgage-related obligations;
- Current debt obligations;
- The monthly debt-to-income ratio, or residual income; and
- Credit history.

In addition, the creditor must underwrite the mortgage payment according to certain assumptions and calculations. Specifically, to calculate the mortgage payment, the proposal requires creditors to use (1) the fully indexed rate; and (2) monthly, substantially equal payments that amortize the loan amount over the loan term. While the general rule is underwriting at the fully indexed rate, a creditor must underwrite based on the introductory interest rate if it is greater than the fully indexed rate, which would help ensure the consumer's ability to repay the loan. The proposal also provides special payment calculations for interest-only loans, negative amortization loans, and balloon loans.[8]

Option 2: Safe Harbor or Presumption of Compliance for a Qualified Mortgage

Section 1412 of the DFA provides that a creditor may presume that a loan meets the minimum standards for the ability-to-repay requirement if the loan is a "qualified mortgage."[9] The definition of "qualified mortgage" is set forth in the statute and generally requires the following features:

- The loan does not contain negative amortization, interest-only payments, or balloon payments;
- The term does not exceed 30 years;
- The points and fees[10] generally do not exceed three percent of the total loan amount;[11]
- The income or assets are considered and verified;
- The total debt-to-income ratio or residual income complies with any guideline or regulation prescribed by the Board; and
- The underwriting: (1) is based on the maximum rate during the first five years, (2) uses a payment schedule that fully amortizes the loan over the loan term, and (3) takes into account all mortgage-related obligations.

With respect to the purpose and effect of Section 1412 of the DFA, the Board notes that it is unclear from the statutory language whether the protection is intended to be a safe harbor or a rebuttable presumption of compliance with the ability-to-repay requirement.[12] Pursuant to Section 1412, a creditor or assignee "may presume" that a loan has met the requirement if the loan meets the definition of a "qualified mortgage." This suggests a presumption of compliance which the consumer can rebut by providing evidence that the creditor did not, in fact, make a good faith and reasonable determination of the consumer's ability to repay the loan. However, the definition does not require a creditor to consider all of the underwriting criteria of the general ability-to-repay standard and may also be considered an alternative or safe harbor provision. The Board notes several policy reasons for interpreting the standard as either a rebuttable presumption or a safe harbor. A safe harbor would provide creditors with protection from liability and a reduced regulatory burden and thus incentivize them to make qualified mortgages. In contrast, a presumption of compliance would require creditors

to make individualized determinations and better ensure that creditors consider a consumer's ability to repay the loan.

In light of the statutory ambiguity, the Board has proposed two alternative definitions of "qualified mortgage," with varying underwriting criteria for each. Alternative 1 defines the term based on the underwriting criteria set forth in the statutory definition as generally described above. The definition would operate as a safe harbor and alternative to the general ability-to-repay standard. Alternative 2 defines a "qualified mortgage" to include the requirements listed in the statutory definition, as well as the other underwriting requirements that are in the general ability-to-repay standard. Thus, under Alternative 2, the creditor would also have to consider and verify:

- The consumer's employment status (and in connection therewith, the consumer's current or reasonably expected income);
- The monthly payments on any simultaneous loans;
- The consumer's current debt obligations;
- The monthly debt-to-income ratio or residual income; and
- The consumer's credit history.

The definition under Alternative 2 would provide a presumption of compliance that could be rebutted by the consumer.

Option 3: Balloon-Payment Qualified Mortgages Made by Certain Creditors

The Proposed Rule provides an exception to the definition of "qualified mortgage," for purposes of the ability to repay, for a balloon-payment loan made by a qualifying creditor that meets the criteria set forth in the Act. The exception is meant to ensure access to credit in rural and underserved areas and is available to creditors who meet the following four criteria:

- *Operates in predominantly rural or underserved areas*. During the preceding calendar year, the creditor extended more than 50% of its total covered transactions that provide for balloon payments in areas the Board designates as "rural" or "underserved."
- *Total annual covered transactions*. The Board does not propose a specific threshold at this time and instead solicits comment on an appropriate dollar amount or number of transactions that should serve as the threshold for this exception. Under one alternative, the creditor would extend covered transactions of some dollar amount or less during the preceding calendar year. Under a second alternative, the creditor would extend some number of covered transactions or fewer during the preceding calendar year.
- *Balloon loans in portfolio*. The Board is proposing two alternative interpretations to implement the statutory requirement that the qualifying creditor must "[retain] the balloon loans in portfolio."[13] Both proposed interpretations would require that the creditor not have sold, assigned, or otherwise transferred legal title to the debt obligation for any balloon payment loan. Under the first alternative, the creditor must not sell any balloon-payment loans on or after the effective date of the final rule. Under a second alternative, the creditor must not have sold any balloon-payment loans during the preceding and current calendar year. The difference between the two alternatives lies entirely in the period during which any such transfer is prohibited.

- *Asset size*. The creditor must meet an asset size threshold set annually by the Board (for calendar year 2011, the amount would be $2 billion).

Except for allowing the balloon payment, the balloon-payment qualified mortgage would contain the same limits on loan features, loan term, and points and fees as a qualified mortgage and would be underwritten using all of the scheduled payments, except the balloon payment. The proposal also requires that the loan term be five years or longer, to allow more time for the consumer to build equity.

Option 4: Refinancing of a Non-Standard Mortgage

The DFA provides an exception to the ability-to-repay standard's underwriting requirements where: (1) the same creditor is refinancing a "hybrid mortgage" or "non-standard mortgage"[14] into a "standard mortgage,"[15] (2) the consumer's monthly payment is reduced through the refinancing, and (3) the consumer has not been delinquent on any payment on the existing hybrid mortgage.[16] This exception appears intended to facilitate streamlined refinancings, which are no- or low-documentation loans designed to quickly refinance a consumer with a risky mortgage into a more stable product. Where the conditions for the exception are met, a creditor may give concerns about preventing a likely default a "higher priority as an acceptable underwriting practice."[17] The Board interprets this provision to provide an exception from the general ability-to-repay requirements for income and asset verification.

The proposal includes specific payment calculations for determining whether refinancing reduces the consumer's monthly payment, and whether the consumer has the ability to repay the standard mortgage. For a non-standard mortgage, the calculation would reflect the highest payment that would occur as of the date of the expiration of the period during which introductory-rate payments, interest-only payments, or negatively amortizing payments are permitted. For a standard mortgage, the calculation would be based on (1) the maximum interest rate that could apply during the first five years, and (2) monthly, substantially equal payments that amortize the loan amount over the loan term.

Anti-Evasion Provision

The exemptions from the ability-to-repay requirement provided for HELOCs and timeshare plans implement the exclusions from the definition of "residential mortgage loan" under new TILA Section 103(cc)(5), as added by Section 1401 of the DFA, which expressly excludes a "consumer credit transaction under an open end credit plan."[18] Given the exclusion for open end credit plans, including HELOCs, the Proposed Rule includes a provision prohibiting a creditor from structuring a closed-end loan as an open-end plan to avoid the ability-to-repay requirement and other requirements for high-cost mortgages and higher-priced mortgage loans. Where a loan is documented as open-end credit but the features and terms or other circumstances demonstrate that it does not meet the definition of open-end credit, the loan is subject to the rules for closed-end credit, including the ability-to-repay requirement.

Restriction on Prepayment Penalties

Consistent with the DFA, the Proposed Rule provides that a transaction may not include a prepayment penalty unless it: (1) has an APR that cannot increase after consummation (*i.e.*, a fixed-rate or step-rate mortgage), (2) is a qualified mortgage, and (3) is not a higher-priced loan. Prepayment penalties are not permitted after the third year after consummation of the loan transaction and may not exceed three percent of the outstanding loan balance during the first year, two percent during the second

year, and one percent during the third year. Additionally, a creditor offering a consumer a loan with a prepayment penalty must also offer that consumer a loan without a penalty.

Record Retention

Because the proposal extends the statute of limitations for civil liability for a violation of the prepayment penalty provisions or ability-to-repay provisions from two to three years after the date of a violation, it also lengthens the record retention requirement in Regulation Z to three years after consummation of a transaction.

Action Plan

Mortgage lenders should solidify an action plan anticipating the implementation of the proposed ability-to-pay requirement and underwriting standards. We recommend that your action plan include the following:

1. A review of your organization's current mortgage loan underwriting practices and consideration of the extent to which current business practices may already comply with one or more of the four compliance options proposed.
2. In connection with the review of current business practices, consider the potential impact of compliance with the ability-to-repay requirement on your business, *e.g.*, to what extent existing practices need to be changed or supplemented with additional employee training or manual updates.
3. Determine which of the proposed alternatives, with respect to the four options to allow a creditor to meet the ability-to-repay requirement, would offer the most flexibility but also business certainty for your operations, and consider whether you would like to make this preference known through a comment letter.
4. To the extent you favor aspects of the Proposed Rule, consider a comment letter highlighting particular benefits to you and your customers given that the CFPB could pursue a more stringent course of action absent meaningful comments on the Proposed Rule.
5. If there are aspects of the Proposed Rule that are flawed, or engender important issues requiring further revision or clarification, consider submitting your comments on the Proposed Rule to address these issues and concerns.

Paul Hastings attorneys are actively working with clients to identify and address the impact of the Proposed Rule on their operations, and are available to assist in drafting comments to the Proposed Rule.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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[1] Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[2] 15 U.S.C. §§ 1601 *et seq*.

[3] DFA § 1402; TILA § 129B(a)(2).

[4] 12 C.F.R. Part 226.

[5] *See* Board Press Release dated April 19, 2011 (announcing the Board's request for public comment on a proposed rule under Regulation Z that would require creditors to determine a consumer's ability to repay a mortgage before making the loan and would establish minimum mortgage underwriting standards), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/20110419a.htm.

[6] While HELOCs are excluded from the scope of coverage for the ability-to-repay requirement (*see* proposed 12 C.F.R. § 226.43(a)(1)), HELOCs are not completely excluded from the Proposed Rule, as the Board proposes to include HELOCs in the definition of "simultaneous loan," so that a HELOC must be considered by a creditor when making a loan that is covered by the repayment ability requirement. *See* proposed 12 C.F.R. § 226.43(c)(2)(iv) and (c)(6) and Staff Interpretation to 43(b)(12), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20110419b1.pdf.

[7] Dodd Frank Act § 1411; TILA § 129C(a)(1).

[8] If a balloon loan is "higher-priced," *i.e.*, the loan's APR exceeds the average prime offer rate ("APOR") by 1.5% for a first-lien loan or by 3.5% for a subordinate-lien loan, the creditor must underwrite the loan by considering the consumer's ability to make the balloon payment without refinancing. For balloon loans that are not higher priced, creditors must underwrite the loan using the maximum payment scheduled during the first five years after consummation.

[9] DFA § 1412; TILA § 129C(b)(1).

[10] A "qualified mortgage" cannot have points and fees that exceed three percent of the total loan amount. The Proposed Rule revises Regulation Z to define "points and fees" to now include: (1) certain mortgage insurance premiums in excess of the amount payable under FHA provisions; (2) all compensation paid directly or indirectly by a consumer or creditor to a loan originator; and (3) the prepayment penalty on the covered transaction, or on the existing loan if refinanced by the same creditor. The proposal provides exceptions for: (1) any bona fide third party charge not retained by the creditor, originator, or an affiliate, and (2) certain bona fide discount points.

[11] The Board has proposed two alternatives for implementing the limits on points and fees. Alternative A is based on certain tiers of loan amounts and is designed to be an easier calculation for creditors, but may result in some anomalies. Alternative B provides a more precise sliding scale, but may be cumbersome for some creditors. For further information on the Board's rationale in regard to the proposed alternatives, see discussion beginning on page 293 of the Board's notice of the Proposed Rule, *available at* http://www.federalreserve.gov/newsevents/press/bcreg/20110419a.htm.

[12] The Board notes that in its 2008 HOEPA Final Rule, a creditor may obtain a presumption of compliance with the repayment ability requirement if it follows the required procedures, such as verifying the consumer's income or assets, and additional optional procedures, such as assessing the consumer's debt-to-income ratio. However, the 2008 HOEPA Final Rule makes clear that even if the creditor follows the required and optional criteria, the creditor has only obtained a presumption of compliance with the repayment ability requirement. The consumer can still rebut or overcome that presumption by showing that, despite following the required and optional procedures, the creditor nonetheless disregarded the consumer's ability to repay the loan.

[13] DFA § 1412; TILA § 129C(b)(2)(E)(iv)(III).

[14] A non-standard mortgage is (1) an adjustable-rate mortgage with an introductory fixed interest rate for a period of years, (2) an interest-only loan, or (3) a negative amortization loan.

[15] A standard mortgage is a covered transaction which, among other things, does not contain negative amortization, interest-only payments, or balloon payments, and limits the points and fees.

[16] DFA § 1411; TILA § 129C(a)(6)(E).

[17] DFA § 1411; TILA § 129C(a)(6)(E)(ii).

[18] Specifically, Section 1401 of the DFA provides that the term "residential mortgage loan" means "any consumer credit transaction that is secured by a mortgage, deed of trust, or other equivalent consensual security interest on a dwelling or on residential real property that includes a dwelling, other than a consumer credit transaction under an open end credit plan or, for purposes of sections 129B and 129C and section 128(a) (16), (17), (18), and (19), and sections 128(f) and 130(k), and any regulations promulgated thereunder, an extension of credit relating to a plan described in section 101(53D) of title 11, United States Code.