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Complying with the CFPB's Qualified Mortgage Rule: Issues for Implementation

BY KEVIN L. PETRASIC & MICHAEL A. HERTZBERG

On January 30, 2013, the Consumer Financial Protection Bureau ("CFPB") published its final rule, pursuant to Sections 1411 and 1412 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("DFA"), amending Regulation Z to require mortgage lenders to take into account a borrower's ability-to-repay when making a mortgage loan (the "Final Rule").[1] The Final Rule also defines "qualified mortgages" ("QMs"), which are presumed to satisfy the ability-to-repay requirement, providing a legal safe harbor for certain QMs, and a rebuttable presumption of compliance for others. In addition, the Final Rule provides for certain exceptions from the QM definition. The Final Rule is scheduled to become effective January 10, 2014. The CFPB also concurrently published a proposal for certain amendments to the Final Rule, including whether or not to include specific types of government-assisted mortgages as QMs, and clarifications about loan originator compensation.

While organizations should be taking steps to prepare for implementing the requirements of the Final Rule approximately 11 months from now, a recent decision of the U.S. Court of Appeals for the D.C. Circuit, *Noel Canning v. NLRB*,[2] may give some organizations pause in doing so. In *Noel Canning*, the court found the January 4, 2012 recess appointment of three members of the National Labor Relations Board ("NLRB") to be invalid. Given that CFPB Director Richard Cordray was appointed at the same time and under the same recess appointment authority as the three members of the NLRB, uncertainty prevails regarding the impact on the CFPB and its rulemakings, including the Final Rule, as a result of the *Noel Canning* decision. An additional wrinkle to this uncertainty is that, in the event that the Final Rule is deemed to be adversely impacted as a result of the *Noel Canning* decision, there remains a provision in the DFA that would cause the statutory provision, including a potentially more restrictive QM standard, to have already taken effect, as of January 21, 2013.[3] A final wrinkle relates to the possibility that the statutory restriction that takes effect (*i.e.,* assuming there is a problem with effectiveness of the Final Rule) would only be effective with respect to banks, with non-banks left in a state of "legal limbo" regarding whether and when they will be subject to an ability-to-repay requirement for mortgage originations.[4]

Given the uncertainty and the extent to which the Final Rule (or a substitute statutory requirement) will require careful planning to implement, banks and non-banks are well-advised to be considering a number of issues and concerns raised by the Final Rule, including both strategic and day-to-day compliance issues. An overview of the Final Rule and discussion of some of these issues and concerns follows.

Ability-to-Repay Determinations

Under the general ability-to-repay standard, mortgage lenders must consider and verify, using reasonably reliable third-party records, 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, alimony, and child support;
- The monthly debt-to-income ratio, or residual income; and
- Credit history.[5]

In its discussion of the Final Rule, the CFPB highlights that it is seeking to eliminate certain practices and limit the use and availability of alternative mortgage products that had a critical role in the 2008 financial crisis. A particular emphasis of the ability-to-repay rule is that it will limit the broad-scale use of so-called "stated-income" loans, as well as the availability of "interest-only" and "negative amortization" loans by limiting incentives for creditors to make such loans.[6] The Final Rule is structured to restrict these practices and the availability of these products by limiting the presumption of compliance associated with QM status, imposing new underwriting requirements regarding verification and documentation, and imposing liability for violating these rules.[7]

While the Final Rule does not require lenders to follow a particular underwriting model, the guidance regarding what is considered a "good faith and reasonable determination" about a consumer's ability-to-repay indicates that the CFPB is offering some latitude to lenders in complying with the ability-to-repay requirements, including a focus on the underwriting process rather than results. The Final Rule notes that the CFPB believes that "this flexibility is necessary given the wide range of creditors, consumers, and mortgage products to which this rule applies," and that not mandating the use of a particular underwriting model is consistent with the legislative intent behind the law.[8] The official commentary to the Final Rule also describes several circumstances where a lender's ability-to-repay determination will be considered to be made in "good faith," including where the lender "used underwriting standards based on empirically derived, demonstrably and statistically sound models."[9] In contrast, situations described in the official commentary in which an ability-to-repay determination is not made in good faith focus on affirmative failures by a lender to comply with the Final Rule, such as disregarding information about a consumer's income or inconsistently applying underwriting standards.[10] Finally, the official commentary notes that "these considerations are not absolute" because "inconsistently applied underwriting standards may be the result of, for example, inadequate training and may nonetheless yield a reasonable and good faith ability-to-repay determination in a particular case."[11]

The discussion in the Final Rule on technical underwriting issues also highlights the degree of latitude that the CFPB is offering lenders to comply with the "good faith and reasonable determination" requirement. For example, in determining income, the Final Rule notes that a lender may consider a consumer's "reasonably expected income" to include an expected bonus that is verified with documentation demonstrating past bonuses, instead of, or in addition to, a consumer's current income.[12] Additionally, the official commentary notes that, with respect to the requirement that a creditor consider any simultaneous loan that it "knows or has reason to know" will be made, the

requirement will be satisfied for a "piggyback" junior loan financing part of a down payment if the creditor "follows policies and procedures that are designed to determine whether at or before consummation the same consumer has applied for another credit transaction secured by the same dwelling."[13]

The Final Rule also provides special payment calculation rules that apply to adjustable-rate mortgages, *e.g.*, the monthly payment must be calculated using the higher of the fully-indexed or introductory rate. There are also special payment rules for loans with balloon payments, interest-only payments, and negative amortization loans. The Final Rule also encourages the refinancing of certain non-standard mortgages into standard mortgages with fixed rates by not requiring those loans to meet the full underwriting process.[14] In addition, the Final Rule bans prepayment penalties for certain fixed-rate, qualified mortgages and requires lenders to keep records demonstrating they have complied with the ability-to-repay rule for at least three years.[15]

Qualified Mortgages

The cornerstone of the Final Rule involves what loans satisfy the requirements of a QM. 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 QM.[16] The definition of what is a QM is set forth in the statute, and the Final Rule largely parallels the statutory list, including the following requirements:

- The loan does not contain negative amortization, interest-only payments, or balloon payments;
- The term does not exceed 30 years;
- The points and fees generally do not exceed three percent of the total loan amount
- 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.
- The income or assets are considered and verified; and
- The total debt-to-income (DTI) ratio or residual income does not exceed 43 percent.[17]

The 43 percent DTI ratio is particularly noteworthy, as it establishes a clear standard and certainty for lenders, rather than a more qualitative evaluation. In its commentary to the Final Rule, the CFPB notes that it chose the 43 percent threshold because "it is an accepted market standard, rates of delinquency and default for borrowers between 36 and 43 percent are still modest, and many borrowers—particularly in higher cost housing markets—borrow at these levels."[18] It is also noteworthy because the DTI threshold used by some government-sponsored enterprises ("GSEs") in their underwriting guidelines is 45 percent.[19] Additionally, the CFPB notes that the 43 percent DTI ratio may act as a proxy indicating that a creditor has acted in good faith to determine a consumer's ability-to-repay, as a DTI ratio above 43 percent "might sweep in many mortgages in which there is not a sound reason to presume that the creditor had a reasonable belief in the consumer's ability-to-repay."[20]

Possibly in recognition of how difficult it might be for certain borrowers to meet such a definite standard and the variety of income sources and obligations present among consumers, the CFPB has also provided an extensive discussion on the standards a lender should use to calculate a consumer's monthly debt and income. The standards, modeled on standards provided by the Federal Housing Administration ("FHA"),[21] include guidance on consumers who receive income from part-time and self-employment, and non-employment related income.

Presumption for Qualified Mortgages

After much debate about the protections to be offered to loans that meet the QM criteria, the Final Rule essentially splits the difference between competing approaches by providing a safe harbor for loans that satisfy the definition of QM and are within certain price thresholds, *i.e.*, loans with an annual percentage rate ("APR") that is within 1.5 percentage points (3.5 percentage points for junior lien loans) of the Average Prime Offer Rate ("APOR").[22] For loans exceeding the price threshold, the Final Rule provides a rebuttable presumption of compliance, a lesser standard of protection.[23] Generally, the line between safe harbor and rebuttable presumption of compliance will fall between QMs made to prime borrowers and those to subprime borrowers. The presumption standards under the Final Rule are as follows:

- *Safe Harbor (for QMs with an APR within 1.5% of the APOR)*: It is "conclusively presumed that the creditor made a good faith and reasonable determination of the consumer's ability-to-repay." This would prevent a consumer from raising issues of non-compliance with the ability-to-repay and QM standard, but would not prevent consumer claims arising under other laws.
- *Rebuttable Presumption (for QMs exceeding the 1.5% APOR threshold)*: A consumer could challenge whether a loan does in fact meet the criteria for a QM, and could also show non-compliance with the Final Rule by showing that repayment of the loan did not leave sufficient income or assets to meet required living expenses.

The CFPB notes in the Final Rule that the decision to offer a safe harbor to QM loans that are not higher priced was based on balancing "new protections for consumers and new responsibilities for creditors with preserving consumers' access to credit and allowing for appropriate lending and innovation," as well as "widespread fear about the litigation risks associated with the Dodd-Frank Act ability-to-repay requirements."[24] The safe harbor, therefore, offers "greater legal certainty for creditors and secondary market participants" as well as consumers by reducing the costs associated with these loans, including expected legal costs from consumers' court challenges.[25]

Regarding the standard for the rebuttable presumption of compliance for higher-priced mortgages, the CFPB notes that while some commenters opposed the use of oral evidence to impeach information contained in a loan file, excluding such evidence "would invite abuses in which consumers could be misled or coerced by an unscrupulous loan originator into keeping certain facts out of the written record."[26] Thus, the Final Rule does not preclude the use of such oral evidence in ability-to-repay cases, and the CFPB believes courts will determine the weight to be given to such evidence on a case-by-case basis. There is a legitimate concern that this could produce greater uncertainty with respect to lenders' legal costs, which would produce disincentives for the origination of such loans.

Exemptions

Another important aspect of the Final Rule involves the available exemptions. These include the following:

- *Temporary Inclusion of Loans Purchased by GSEs*: Noting that lenders "may initially be reluctant to make loans that are not QMs, even though they are responsibly underwritten," the CFPB included a temporary category of mortgages that are deemed QMs provided the loans meet the statutory criteria "regarding prohibitions on certain risky loan features and limitations on points and fees."[27] These requirements include that a loan:
    - Have regular periodic payments that do not result in an increase in the principal balance, or allow for the deferral of principal repayment;

- Not result in a balloon payment;
- Have a maximum loan term not to exceed 30 years;
- Not exceed the maximum points and fees for the loan category specified in the Final Rule (see below); and
- Meets the underwriting requirements of, and is eligible for purchase, insurance, or guarantee by, Fannie Mae, Freddie Mac or other government housing agencies.[28]

Notably, these criteria do not include the 43 percent DTI threshold required by the Final Rule. This category expires at the earlier of: (1) seven years, or (2) the end of the conservatorship of Fannie Mae and Freddie Mac, or for the other government housing agencies, such as the Department of Veterans Affairs or FHA, when they adopt their own criteria for QMs.[29]

- *Rural Balloon Payment Qualified Mortgages*: The Final Rule also provides an exception to certain rural-based lenders for balloon-payment mortgage loans that would not otherwise meet the QM standards for loans originated by lenders in rural or underserved areas. To qualify for this exception, such loans must meet the following criteria:
  - Have a fixed interest rate;
  - Have a term of at least five years;
  - Meet certain standard underwriting criteria; and
  - Be originated by lenders with assets of less than $2 billion, that originate at least 50 percent of their first-lien mortgage loans in counties that are rural or underserved, and originate no more than 500 first-lien mortgage loans per year.[30]

Proposed Adjustments to the Final Rule

Concurrently, the CFPB also proposed amendments to the Final Rule requesting comments on whether mortgages originated by the following specific entities should be considered QMs:

- Nonprofit lenders that work to help low- to moderate-income consumers obtain affordable housing;
- Housing finance agencies and lenders that participate in housing finance agency programs intended to foster community development;
- Homeownership stabilization programs that work to prevent foreclosure, such as programs that operate with the Make Home Affordable program; and
- Mortgage loans originated by smaller creditors, such as community banks and credit unions that originate and hold mortgage loans in their own portfolios.

The CFPB is also seeking comment on whether to clarify certain aspects of loan originator compensation, namely: (1) if payments from a consumer directly to a mortgage broker do not need to be counted twice towards the points and fees cap, and (2) if payments from a mortgage broker to its loan originator employees also do not need to be included in the calculation if the payment to the broker is already included. Additionally, the CFPB is seeking comments on alternative proposals on

how to treat employee loan originator compensation, which continues to be an important consideration in certain market segments.

Issues and Concerns

While initial reviews of the Final Rule have generally been favorable, there are a number of outstanding issues and concerns that include the following:

- *Impact on Jumbo Loans*: One of the biggest problems with the Final Rule relates to the line drawn for jumbo mortgage loans, which typically have higher rates than conforming loans and exceed the maximum loan amount that Fannie Mae and Freddie Mac will buy. While the CFPB asserts that the application of the 1.5 percentage point threshold will not limit access to credit for those homebuyers requiring jumbo loans, the impact of the Final Rule in high-price regions remains to be seen.[31] Certainly, there is some incremental risk given the treatment of QMs, and this risk will likely equate to some type of pricing incremental for jumbo mortgage loan products.
- In addition, it is important to note the impact on the jumbo loan market of the requirement under the Final Rule that interest-only mortgages not be treated as QMs. Specifically, the Final Rule provides that a QM does not allow a consumer to defer repayment of principal (except in limited circumstances). Given that a segment of the jumbo market involves deferred principal/interest-only loans, even if such loans fall within the 1.5 percentage point pricing threshold, such jumbo loans would be excluded as QMs. There is also a similar concern with the 43 percent DTI ratio, given that a segment of jumbo loan borrowers typically exceed this QM threshold.
- *Uncertainty Regarding the QM Rebuttable Presumption*: While the CFPB notes that the rebuttable presumption for certain higher-priced mortgages offers some protection to lenders, in practice, this protection may be somewhat limited. As noted above, a consumer can overcome the rebuttable presumption by demonstrating that, at the time the loan was made, the consumer lacked sufficient residual income or assets to meet living expenses. Depending on how this is implemented by the courts, this may turn into a highly subjective standard that penalizes lenders for unrelated changes in a consumer's financial position, and so results in increased documentation and litigation costs for higher-priced mortgages, further reducing the incentive for lenders to make these types of loans.
- *Fair Lending Compliance Issues*: An additional concern for lenders will be how to comply with the QM standard while not raising concerns under the disparate impact analysis used in fair lending compliance. As noted above, the practical effect of the limited legal safe harbor established by the Final Rule will be that lenders will make fewer loans to subprime borrowers, which typically include a larger percentage of protected minority groups relative to the overall population. This raises the possibility that a lender adhering to the standards of the Final Rule could find itself facing potential fair lending compliance issues under the Fair Housing Act and the Equal Credit Opportunity Act. To mitigate this problem, lenders should make sure that mortgage loan policies and procedures provide for careful documentation of adverse lending decisions. Further, organizations should make sure that mortgage loan processors review, be trained on, and strictly adhere to internal documentation and recordkeeping procedures to ensure compliance with fair lending laws, particularly with respect to overlapping issues that could be created in connection with implementing the Final Rule.
- *Uncertainty Regarding the Recess Appointment of CFPB Director Cordray and Implications for a More Stringent Standard*: As noted at the outset, one recent wrinkle to deciphering the

impact of the Final Rule is the *Noel Canning* decision, finding the January 4, 2012 recess appointment of three members of the NLRB to be invalid.[32] CFPB Director Cordray was appointed on the same day as the NLRB members, and the decision not only creates uncertainty about his own status, but also about the validity of various regulations promulgated by the CFPB since his appointment. In terms of the Final Rule, even if a court were to find eventually that Director Cordray's appointment was invalid, the impact on the QM standard may be more difficult to discern. Under the DFA, if the CFPB is unable to implement a final rule detailing the QM standard by January 21, 2013, then the QM standard provided in the statute takes effect.[33] While the Final Rule generally tracks the statutory standard, the statutory standard is more restrictive for lenders (*e.g.,* there is no legal safe harbor), and has more ambiguities in its terms, resulting in increased compliance costs and, as previously described, greater uncertainty for lenders.

- *Homogenization of Housing Credit*: For the overall housing market, the result of the Final Rule will be to homogenize the market for housing credit by incentivizing lenders to provide mortgage products that favor standard, prime borrowers, or mortgage products that conform to Fannie Mae/Freddie Mac standards. Groups that will be disadvantaged by the Final Rule include borrowers seeking jumbo loans, subprime borrowers, and borrowers who, because they have atypical financial circumstances, *i.e.,* irregular income streams, prefer a non-standard mortgage product. For these borrowers, the Final Rule will result in reduced access to credit and, when such credit is available, it will come at a higher price. While the CFPB has argued that these costs are small compared to the benefits that the vast majority of borrowers will see under the Final Rule, as well as the reduced systemic risk to the housing finance system, nonetheless, the post-Final Rule mortgage market will feature reduced risks and costs for typical borrowers, but likely provide for less product diversity and innovation.

Action Plan for Mortgage Lenders

Mortgage lenders should continue to monitor what impact, if any, the U.S. Court of Appeals' recent recess appointment decision has on the CFPB and the Final Rule. However, mortgage lenders should also solidify an action plan to implement the Final Rule and its various requirements, particularly given the possibility of a similar substitute statutory requirement that would be triggered, effective January 21, 2013. We recommend that your action plan include the following:

1. A review of your organization's current mortgage loan underwriting policies and practices and consideration of the extent to which current business practices may already comply with the ability-to-repay requirement and/or require modification to do so.
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 and product offerings, *e.g.*, to what extent existing mortgage loan products and/or practices need to be modified, changed, or supplemented with additional employee training or manual updates, or eliminated altogether (*i.e.,* in the case of certain loan products).
3. A top-to-bottom review of all existing mortgage compliance policies and programs, and enterprise-wide documentation standards to assess potential issues related to compliance with the Final Rule, and the extent to which modifications are required to document compliance, as well as the basis for the denial or mortgage credit to applicants.
4. A parallel review of your organization's Fair Lending compliance and documentation standards to avoid potential challenges that could arise under the Fair Lending laws, as noted above, due to implementation and compliance with the Final Rule.

5. An assessment of potential litigation and compliance risks arising under your existing mortgage program, and steps that may be necessary to address or mitigate such risks.

6. An assessment of longer-term mortgage lending strategies and potential opportunities (and risks) that could arise under the Final Rule's QM regime.

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

Atlanta

Chris Daniel
1.404.815.2217
chrisdaniel@paulhastings.com

Heena A. Ali
1.404.815.2393
heenaali@paulhastings.com

Todd W. Beauchamp
1.404.815.2154
toddbeauchamp@paulhastings.com

Kevin Erwin
1.404.815.2312
kevinerwin@paulhastings.com

Diane Pettit
1.404.815.2326
dianepettit@paulhastings.com

Palo Alto

Cathy S. Beyda
1.650.320.1824
cathybeyda@paulhastings.com

San Francisco

Thomas Brown
1.415.856.7248
tombrown@paulhastings.com

Stanton R. Koppel
1.415.856.7284
stankoppel@paulhastings.com

Kristin M. Hall
1.415.856.7071
kristinhall@paulhastings.com

Samuel Zun
1.415.856.7206
samuelzun@paulhastings.com

Washington, D.C.

V. Gerard Comizio
1.202.551.1272
vgerardcomizio@paulhastings.com

Behn Dayanim
1.202.551.1737
bdayanim@paulhastings.com

Kevin L. Petrasic
1.202.551.1896
kevinpetrasic@paulhastings.com

Erica Berg-Brennan
1.202.551.1804
ericaberg@paulhastings.com

Lawrence D. Kaplan
1.202.551.1829
lawrencekaplan@paulhastings.com

Ryan A. Chiachiere
1.202.551.1767
ryanchiachiere@paulhastings.com

Michael A. Hertzberg
1.202.551.1797
michaelhertzberg@paulhastings.com

Amanda M. Jabour
1.202.551.0376
amandajabour@paulhastings.com

Carla Laroche
1.202.551.1768
carlalaroche@paulhastings.com

Helen Y. Lee
1.202.551.1718
helenlee@paulhastings.com

Lily Woodland
1.202.551.1977
lilywoodland@paulhastings.com

1 CFPB, Final Rule, *Ability to Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z)*, 78 Fed. Reg. 6408 (Jan. 30, 2013) (to be codified at 12 C.F.R. Part 1026) ("Final Rule").

2 *Noel Canning v. NLRB*, No. 12-1115 (D.C. Cir. Jan. 25, 2013).

3 DFA § 1400(c)(3).

4 In this regard, the U.S. Treasury Department has taken the position that, pursuant to DFA § 1066(a), it can supervise banks, the jurisdiction of which was passed to the CFPB from the other federal banking agencies pursuant to Subtitle F and Title X of the DFA; however, there is no similar provision addressing the supervision of non-banks otherwise subject to the CFPB's jurisdiction (*i.e.,* notwithstanding the *Noel Canning* decision).

5 *See* 12 C.F.R. § 1026.43(c)(2).

6 Final Rule, 78 Fed. Reg. at 6562.

7 *Id.*

8 Final Rule, 78 Fed. Reg. at 6461.

9 *See id. §* 1026.43, Supplement I, Comment-43(c)(1)(ii)(A).

10 *See id.* § 1026.43, Supplement I, Comment-43(c)(1)(ii)(B).

11 *See id.* § 1026.43, Supplement I, Comment-43(c)(1)(ii)(C).

12 Final Rule, 78 Fed. Reg. at 6464.

13 *See* 12 C.F.R. § 1026.43, Supplement I, Comment-43(c)(2)(iv)(2).

14 *See id.* § 1026.43(d)(2).

15 *See id.* § 1026.43(g); *see also id.* § 1026.25(a).

16 *See* 15 U.S.C. § 1639c.

17 *See* 12 C.F.R. § 1026.43(e).

18 Final Rule, 78 Fed. Reg. at 6575.

19 For example, Fannie Mae's DTI threshold is 45 percent. *See* Fannie Mae Single Family Seller/Servicer Guide, p.486 (2012).

20 Final Rule, 78 Fed. Reg. at 6528.

21 *See* 12 C.F.R. § 1026, Appendix Q.

22 *Id.* § 1026.43(e)(1)(i).

23 *Id.* § 1026.43(e)(1)(ii).

24 Final Rule, 78 Fed. Reg. at 6505.

25 *Id.* at 6507, 6509.

26 *Id.* at 6512.

27 *Id.* at 6534.

28 12 C.F.R. § 1026.43(e)(4)(i).

29 *Id.* § 1026.43(e)(4)(iii).

30 *Id.* § 1026.43(f)(1).

31 Final Rule, 78 Fed. Reg. at 6528–29.

32 *See supra,* note 2.

33 *See* DFA § 1400(c); 15 U.S.C. § 1601 note.

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