CLIENT UPDATE

CFPB ISSUES FINAL RULE ESTABLISHING ABILITY TO REPAY AND QUALIFIED MORTGAGE STANDARDS

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On Thursday, January 10, 2013, the Consumer Financial Protection Bureau ("CFPB" or "Bureau") issued a long-awaited final rule setting forth the Ability to Repay and Qualified Mortgage ("QM") standards. The final rule, which promises to have significant implications for the U.S. mortgage market and lending practices, fulfills the mandate of sections 1411 and 1412 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act" or "Act"), which require creditors to make a reasonable, good faith determination that a borrower has the ability to repay most residential mortgages before making them and establish certain protections from liability for QMs.

The Bureau also issued a new proposal to amend the final rule, among other things, to provide special new exemptions for small portfolio creditors and certain other lending programs, with comments due by February 25, 2013. The final rule will become effective in one year – on January 10, 2014.

BACKGROUND AND HIGHLIGHTS

In reaction to the financial crisis, the Dodd-Frank Act required that, before making certain residential mortgage loans, creditors must make a "reasonable and good faith determination" based on verified and documented information that a borrower has a reasonable ability to repay the loan according to its terms. The Act also created

a presumption of compliance for a certain category of loans, QMs. The final rule issued last week by the CFPB defines with considerable detail the parameters of the ability to repay determination and the features of a QM. The Bureau's 804-page regulation is summarized below, but we first note a couple of its most important developments.

Additions to the QM Definition. The rule contains two major additions to the QM definition, which are expansions to what the Federal Reserve Board ("Board") originally proposed, before authority passed to the CFPB, and the requirements mandated by the Act. In addition to the statutory limits on certain risky loan features (such as negative amortization and terms in excess of 30 years) and cap on points and fees, the final rule adds a permanent new underwriting requirement that QMs must have a debt-to-income ("DTI") ratio equal to or less than 43%. In addition, the final rule adds a "temporary" (up to seven years) alternative underwriting requirement that a QM can meet instead of the 43% DTI ratio by satisfying the eligibility standards of the government sponsored enterprises ("GSEs"), Fannie Mae and Freddie Mac, or of the federal government mortgage insurance programs of HUD/FHA, the Department of Veterans Affairs ("VA"), the Department of Agriculture, and the Rural Housing Service ("RHS"). The Bureau estimates that (without the temporary GSE or government agency eligibility standard) almost 80% of loans in the 2011 mortgage market would have satisfied the QM definition.

Safe Harbor and Rebuttable Presumption. One of the more controversial questions the Board had posed in its proposal was whether satisfying the QM standard should mean that a lender would thereby have a rebuttable presumption of compliance with the Ability to Repay rule or if meeting the QM standard would instead be a true "safe harbor," conclusively deemed to satisfy that rule. As some had expected, the final rule takes a two-tier approach. For the vast majority of QMs, those originated in the "prime" market, the final rule provides that the QM standard will be a conclusive safe harbor. Satisfying the QM definition will irrefutably be deemed to satisfy the Ability to Repay rule, and the only way a borrower could prove a violation would be by showing that the loan in fact did not meet the QM standard. For what are defined in the final rule as "higher-priced" loans – 150 basis points above the average prime offer rate for first liens, and 350 basis points for second liens – the QM standard will act only as a rebuttable presumption, which a borrower can overcome by showing that, even though the loan met the QM definition, it was nonetheless made without meeting the overarching standard of a reasonable and good faith determination that the borrower would have a reasonable ability to repay it.

Providing a conclusive safe harbor for lower-priced, or prime, loans was widely sought by the mortgage industry and will provide an important protection for both lenders and purchasers of mortgages. In this area, the industry is breathing a sigh of relief. In the

much smaller, higher-priced segment of the market, however, there are significant concerns about the possible impact of a rebuttable presumption approach combined with the defenses and claims available to borrowers under the rule against both creditors and assignees. In addition, there remain concerns that certain components of the points and fees cap for QMs, in particular the inclusion of certain types of loan originator compensation and fees for affiliated settlement service providers, which are discussed below, could have a major adverse impact on the services of those providers.

Mortgage Implementation Team. At the field hearing announcing the new rule, CFPB Director Richard Cordray also announced that the Bureau would name a business person from the industry to lead its effort to assist mortgage creditors with the implementation of the new mortgage rules. We understand that Lisa Applegate, formerly at Fannie Mae, will be the Mortgage Implementation Team Lead in the Bureau's division of Research, Markets & Regulations.

Forthcoming Rulemakings. In addition to the Ability to Repay rule, the Bureau also finalized on January 10 other rules amending Regulation Z requirements regarding escrow accounts for higher-priced mortgage loans and regarding mortgage loans that are subject to the protections of the Home Ownership and Equity Protections Act of 1994 ("HOEPA"), including certain requirements related to homeownership counseling. The Bureau is widely expected to finalize other rules required by the Dodd-Frank Act at its next field hearing, this Thursday, January 17, such as the widely anticipated new servicing rules amending Regulations Z and X and amendments regarding the loan originator compensation rules. The integration of all the mortgage disclosure rules is expected from the Bureau in the fall of 2013.

Qualified Residential Mortgage. A larger, separate group of federal regulators, including the prudential banking regulators and the Securities and Exchange Commission, also are expected to release this year a rule implementing the "risk retention" requirements of Section 941 of the Dodd-Frank Act. Section 941 generally requires lenders to retain 5% of the credit risk of residential mortgages they originate that are pooled into mortgage-backed securities. Mortgages that meet the definition of a "Qualified Residential Mortgage" ("QRM"), however, are exempt from this "skin in the game" requirement (as are Fannie Mae and Freddie Mac mortgages). To meet the QRM exemption, a mortgage must satisfy certain underwriting standards, including requirements relating to the loan term, points and fees, DTI ratio, loan-to-value ratio, down payment, and the borrower's financial information. Although the Act does not prescribe these requirements in detail, the Act does require that the definition of a QRM can be no broader than the definition of a QM. Thus, the QM final rule now sets the outer boundaries for what loans can qualify as

QRMs. Now that the QM rule is final, it is possible the QRM final rule could also be issued soon, as has been suggested in recent remarks from Comptroller of the Currency Thomas Curry.

GENERAL ABILITY TO REPAY STANDARD

Section 1412 of the Dodd-Frank Act requires creditors to take into account a borrower's ability to repay the mortgage before extending credit. Pursuant to the new Ability to Repay rule, lenders must evaluate and verify a borrower's financial records and make a "reasonable and good faith determination" that the borrower "will have a reasonable ability to repay" the mortgage over the long term. 12 C.F.R. § 1026.43(c)(1).

To satisfy the new rule, lenders must consider, at a minimum, the following eight underwriting standards when determining a borrower's ability to repay the mortgage: (1) current or reasonably expected income or assets; (2) current employment status; (3) the monthly payment on the covered 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 DTI ratio or residual income; and (8) credit history. 12 C.F.R. § 1026.43(c)(2)(i)-(viii).

The final rule creates an exemption from these requirements to encourage certain types of refinancings. In particular, lenders do not have to engage in an Ability to Repay determination if they are refinancing a risky "non-standard mortgage" – *e.g.*, certain adjustable-rate, interest-only or negative-amortization mortgages – to a "standard mortgage," defined as a mortgage with a fixed rate and a term of at least five years. 12 C.F.R. § 1026.43(d)(3).

QUALIFIED MORTGAGES

Section 1412 of the Dodd-Frank Act creates a presumption that "qualified mortgages" have satisfied the Ability to Repay requirements. The final rule defines the features of QMs and the protections that apply to such loans.

General Requirements

To qualify for an exemption from the Ability to Repay requirements, a QM must meet the following criteria: (1) regular periodic payments that may not increase the principal balance (no negative amortization loans), allow deferment of principal repayment (must fully amortize), or result in a balloon payment, except if it falls under the exemption for Rural Balloon-Payment Qualified Mortgages (*see infra*); (2) points and fees must not exceed

allowable amounts (*e.g.*, points and fees are capped at 3% for loans $100,000 and above and with tiered higher caps for smaller loans; *see infra*); (3) the loan must be underwritten using (i) the maximum rate allowed during the first five years, and (ii) periodic payments of principal and interest to repay either the outstanding principal over the loan term once that maximum interest rate is reached or the loan amount over the loan term; (4) the loan term may not exceed 30 years; (5) the creditor must consider and verify the borrower's "current or reasonably expected income or assets" and "current debt obligations"; and (6) the ratio of total monthly debt to total monthly income must not exceed 43%. 12 C.F.R. § 1026.43(e)(2)(i)-(vi).

Scope of QM Safe Harbor

As noted, the scope of protections afforded to QMs differs based on the interest rate of the mortgage. If the annual percentage rate exceeds the average prime offer rate by 1.5 percentage points or more for first liens and 3.5 percentage points or more for second liens, the mortgage is deemed a "higher-priced" QM. Higher-priced QMs are entitled to a rebuttable presumption that they comply with the Ability to Repay requirements. 12 C.F.R. § 1026.43(e)(1)(ii)(A). To rebut the presumption of compliance, a consumer would have to prove that the creditor did not in fact "make a reasonable and good faith determination of the consumer's repayment ability at the time of consummation," by showing that the consumer's income and debt obligations at the time of origination would leave the consumer with insufficient residual income. 12 C.F.R. § 1026.43(e)(1)(ii)(B). Thus, borrowers facing foreclosure on a "higher-priced" QM are entitled to assert as a defense the creditor's or assignee's violation of the Ability to Repay requirements, so long as they are able to make a showing rebutting the presumption of compliance. There is no statute of limitations on the use of this defense, but the amount of damages is limited to no more than three years of finance charges and fees.

If the QM bears a lower interest rate, then it qualifies for a safe harbor under which it is conclusively presumed to comply with the Ability to Repay requirements. 12 C.F.R. § 1026.43(e)(1)(i). Consumers can still challenge such loans under the rule but only by showing that the loan does not meet the definition of a QM.

Temporary Category of QMs for Loans that Satisfy GSE or Government Mortgage Insurance Underwriting Standards

The final rule also temporarily grants QM status to loans eligible to be purchased, guaranteed, or insured by Fannie Mae, Freddie Mac, HUD, the VA, the Department of Agriculture, or the RHS. 12 C.F.R. § 1026.43(e)(4)(ii). To qualify, the loan must also satisfy

some of the other limits generally applicable to QMs, specifically: (1) regular periodic payments may not increase the principal balance (no negative amortization loans), allow deferment of principal repayment (must fully amortize), or result in a balloon payment, except if it falls under the exemption for Rural Balloon-Payment Qualified Mortgages; (2) points and fees must not exceed the allowable thresholds at 3% or higher for smaller loans; and (3) the loan term may not exceed 30 years. 12 C.F.R. § 1026.43(e)(2). Such loans do not need to satisfy any of the other requirements for a QM; perhaps most importantly, they need not satisfy the 43% DTI ratio requirement.

This provision will sunset over time as the various federal agencies issue their own QM rules and if GSE conservatorship ends, and in any event after seven years.

Rural Balloon-Payment QMs

Certain QMs may provide for a balloon payment if they are originated and held in portfolio by small creditors that (i) operate predominantly in rural or underserved areas, (ii) originated 500 or fewer first-lien mortgages in the previous year, and (iii) have total assets of less than $2 billion. 12 C.F.R. § 1026.43(f).

To qualify, the mortgage must: (1) not have payments that result in an increase of the principal balance; (2) not exceed a term of 30 years; (3) comply with the points and fees limitations applicable to QMs; (4) have an interest rate that does not increase over the term of the loan; and (5) include creditor consideration and verification of the borrower's "current or reasonably expected income or assets," "current debt obligations," and DTI ratio to evaluate whether the consumer can make all scheduled payments, excluding the balloon payment. 12 C.F.R. § 1026.43(f)(1)(i)-(iv).

The CFPB has also invited comment on a proposed amendment to the rule that would define a "higher-priced" QM differently for balloon-payment QMs. Under the proposal, a balloon-payment QM with an annual percentage rate that exceeds the average prime offer rate by 3.5 percentage points – not 1.5 percentage points – would qualify as a higher-priced covered transaction. Proposed 12 C.F.R. § 1026.43(b)(4). This proposed rule would expand the number of balloon-payment QMs that would fall under the more protective conclusive safe harbor rather than the rebuttable presumption.

Limit on Points and Fees

To fall within the QM safe harbor, points and fees payable in connection with the loan must not exceed the following inflation-adjusted amounts: 3% on loans $100,000 and

greater; $3,000 on loans $60,000 to $100,000; 5% on loans $20,000 to $60,000; $1,000 on loans $12,500 to $20,000; and 8% on loans less than $12,500. 12 C.F.R. § 1026.43(e)(3).

Allowable points and fees are defined in 12 C.F.R. § 1026.32(b)(1). They include: (1) all items included in the finance charge *except* the following: (i) interest, (ii) most government and private mortgage insurance charges, (iii) bona fide third-party charges not retained by the creditor, loan originator, or an affiliate of either, and (iv) up to two bona fide discount points if the interest rate without any discount does not exceed the average prime offer rate by more than one percentage point, or up to one discount point if the interest rate does not exceed the average prime offer rate by more than two percentage points; (2) all compensation "paid directly or indirectly by a consumer or creditor to a loan originator" that can be "attributed to that transaction"; (3) all fees listed in 12 C.F.R. § 1026.4(c)(7), including title fees, notary and credit report fees, appraisal fees, and escrow charges, *unless* (i) the charges are reasonable, (ii) the creditor receives no direct or indirect compensation in connection with the charge, and (iii) the charge is not paid to an affiliate of the creditor; (4) prepayment penalties; and (5) premiums for any credit insurance or other insurance for which the creditor is a beneficiary. 12 C.F.R. § 1026.32(b)(1)(i)-(vi).

The CFPB is also proposing official interpretations to clarify how the calculation of the points and fees cap will include loan originator compensation. Under 12 C.F.R. § 1026.32(b)(1)(ii), all compensation paid directly or indirectly by a consumer or creditor to a loan originator that can be attributed to that transaction is required to be included in points and fees. Several industry commenters have noted that including loan originator compensation in points and fees could result in "double-counting" because money collected in up-front charges from consumers could, under the literal language of the rule, be counted a second time toward the points and fees thresholds if it is passed on to a loan originator.

To address this concern, the CFPB is seeking additional public comment on proposed official interpretations to specify accounting methods for the inclusion of loan originator compensation. The first proposed interpretation, 32(b)(1)(ii)-5.i, would provide that mortgage broker fees paid by a consumer that are already included as points or fees because they are included in the finance charge need not be counted again as loan originator compensation. The second proposed interpretation, 32(b)(1)(ii)-5.ii, would clarify that a creditor is not required to include downstream payments by a mortgage broker to its own individual loan originator employees in the points and fees calculation. Finally, the CFPB offered two alternative versions of its third proposed interpretation, 32(b)(1)(ii)-5.iii. The first option would enshrine a double-counting approach by specifying that a creditor must include compensation paid by a consumer or creditor to a

loan originator in the calculation of points and fees *in addition to* any points or fees paid by the consumer to the creditor. For example, the calculation would include both an origination fee paid by the consumer to the creditor and compensation the creditor pays to its loan officer employee attributable to the transaction. Under the second alternative, which addresses mortgage industry concerns about double-counting, consumer payments of points and fees to the creditor would offset creditor payments to the loan originator.

PROPOSED AMENDMENT TO EXTEND QM STATUS TO LOANS MADE BY SMALL LENDERS AND OTHER PROGRAMS

The CFPB also invited comment on a proposed amendment to the Ability to Repay rule, proposed 12 C.F.R. § 1026.43(e)(5), that would give QM status to certain mortgages made by small creditors, such as community banks and credit unions, that make and hold loans in their own portfolios. The mortgages would not need to satisfy the 43% DTI ratio requirement applicable to other QMs. 12 C.F.R. § 1026.43(e)(5)(i)(A). The amendment also defines a "higher-priced" mortgage differently for such creditors – a first-lien mortgage with an annual percentage rate that exceeds the average prime offer rate by 3.5 percentage points – not 1.5 percentage points – would qualify as a higher-priced covered transaction.

Other proposed amendments to the final rule would include exemptions from the Ability to Repay requirements for certain nonprofit creditors and homeownership stabilization programs. The proposed amendments also would exempt certain federal refinancing programs administered by Fannie Mae, Freddie Mac, the FHA, the VA, and the Department of Agriculture from the Ability to Repay requirements.

CONCLUSION

The QM standard specified in the final Ability to Repay rule issued by the Bureau could well define a crucial boundary for the vast majority of mortgages that will be originated in the U.S. mortgage market of the future. The significant defenses and claims that the Dodd-Frank Act provides to a borrower to raise in foreclosure actions may make it very difficult for lenders to make, or for assignees to purchase, mortgages other than QMs, or potentially even those higher-priced QMs that are subject to a rebuttable presumption of compliance rather than a safe harbor. There are more rules to come, but the final Ability to Repay rule is an important foundation in the remaking of U.S. mortgage regulation.

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Debevoise & Plimpton's Consumer Finance Group regularly advises clients in consumer financial protection matters, including those involving residential mortgage lending. Please do not hesitate to contact us with any questions.

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