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Consumer Financial Protection Bureau Issues Ability-to-Repay and Qualified-Mortgage Standards Implementing Dodd-Frank

On January 10, 2013, the Consumer Financial Protection Bureau ("CFPB") published highly anticipated final rules implementing sections 1411, 1412, and 1414 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank"). The CFPB regulations set out in greater detail Dodd-Frank's amendments to the Truth In Lending Act ("TILA"), which require creditors to assess a consumer's ability to repay before making a residential mortgage loan, and define "qualified mortgages" that presumptively comply with the ability-to-repay requirements. **The new rules will take effect on January 10, 2014.**

Non-compliance with the ability-to-repay rules may subject creditors—and their assignees—to consumer suits for statutory damages and attorneys' fees. Such suits may be brought within three years from occurrence of the violation (as opposed to the shorter one-year statute of limitations for most other TILA violations). There is, however, no time limit on a consumer's ability, in a foreclosure action, to bring a defensive claim for recoupment or set-off based on an alleged ability-to-repay violation.

Under the rules, only a qualified mortgage will be eligible to be a "qualified residential mortgage" exempt from Dodd-Frank's forthcoming "skin-in-the-game" rules for asset-backed securities.

Key provisions of the new rules are described below.

Ability to Repay

Under Dodd-Frank, creditors may not make a residential mortgage loan unless they make a "reasonable and good faith determination" that the consumer has a "reasonable ability" to repay the loan. The consumer's ability to repay must be verified through third-party documentation. Creditors generally must consider a minimum of eight underwriting factors: (1) credit history, (2) current and expected income or assets, (3) employment status, (4) monthly debt-to-income ratio or residual income, (5) current debt obligations, alimony, and child support, (6) the monthly payment for mortgage-related obligations, (7) the monthly payment on the subject loan, and (8) the monthly payment on any simultaneous loan. In general, in determining the consumer's ability to repay, creditors must assume that the consumer will repay the loan in substantially equal monthly amortizing payments.

The CFPB's new rules clarify the types of income and assets that may be considered in the ability-to-repay determination, the permissible sources for verification, and the required methods of calculating the loan's monthly payments. For example, the rules extend the requirement that creditors verify and document a borrower's "income and assets" to include all "information" that creditors rely on in determining repayment ability. The rules also provide further examples of third-party documents that may be relied on for such verification, such as government records and check-cashing or funds-transfer service receipts. Special rules apply to forecasting the consumer's monthly payments under mortgages that provide for balloon payments, interest-only payments, or negative amortization. For instance, where "higher-priced" mortgages include a balloon payment, creditors must determine the consumer's ability to make the balloon payment; for mortgages that are not higher-priced, creditors need only determine the consumer's ability to make the highest payment due in the first five years of the loan.

The CFPB's new rules create a further exemption to Dodd-Frank's ability-to-repay requirement when a "non-standard mortgage" is refinanced into a "standard mortgage." A non-standard mortgage is an adjustable-rate, interest-only, or negative amortization loan. A standard mortgage is similar to a "qualified mortgage" within the meaning of the rules, as discussed further below, but its term may be up to 40 years (as opposed to 30), and the interest rate must be fixed for at least 5 years. Unlike the statutory refinancing exemptions, a refinancing under the new rules requires that the new interest rate be "materially" lower, that the consumer apply in writing less than 2 months after the non-standard mortgage recasts, that the consumer has not been late on payments, and that the refinancing is "likely" to prevent a default.

Qualified Mortgages

Dodd-Frank presumes a borrower's ability to repay if the mortgage is a qualified mortgage ("QM"), and defines QMs to exclude mortgages with characteristics that were perceived to have precipitated the subprime mortgage crisis: loans with negative amortization, loans with balloon payments or interest-only payments, and so-called "no-doc" loans for which verification of income was not required. The loan term for a QM may not exceed 30 years, and total points and fees to the originator, creditor, or affiliates generally may not exceed 3%. (For loans less than $100,000, the new rule permits points and fees in excess of 3% up to defined limits.)

Dodd-Frank authorized the CFPB to "revise, add to, or subtract from" the definition of a QM. One significant addition is the requirement that a QM leave the consumer with a total (or "back-end") debt-to-income ratio less than or equal to 43%—a ratio that Dodd-Frank delegated to the CFPB to define. Appendix Q to the rules provides detailed standards for calculating the debt-to-income ratio.

Loans that are eligible to be purchased, guaranteed, or insured by the Federal National Mortgage Association ("Fannie Mae"), Federal Home Loan Mortgage Corporation ("Freddie Mac") (together, the "GSEs"), and various federal agencies are temporarily exempt from the required debt-to-income ratio. This exemption will phase out on January 10, 2021, or earlier if the agencies promulgate their own rules or the GSE conservatorship ends.

Small creditors operating in predominantly rural or underserved areas are exempt from the balloon payment prohibition and the 43% maximum debt-to-income ratio (although they must still consider the back-end debt-to-income ratio). Balloon payment mortgages may not be assigned by small creditors for 3 years except to another such creditor, in a bankruptcy or similar proceeding, or pursuant to a merger or acquisition.

Prepayment Penalties

Dodd-Frank prohibits prepayment penalties for non-qualified mortgages, adjustable rate mortgages, and higher-priced mortgages. For other mortgages, prepayment penalties are capped at 3%, 2%, and 1% for the first, second, and third years, respectively, and prohibited thereafter. Further, creditors may not consummate a loan that contains a prepayment penalty without also offering a loan that does not contain a prepayment penalty.

The CFPB's new rules reduce permitted prepayment penalties to 2% during the first two years and 1% during the third year following consummation. The rules also require that the non-prepayment-penalty offer have certain terms in common with the prepayment-penalty offer.

Safe Harbor or Rebuttable Presumption?

Perhaps the most significant policy choice facing the CFPB was whether to structure Dodd-Frank's qualified-mortgage presumption as a conclusive safe harbor or a rebuttable presumption. Consumer groups lobbied aggressively against a safe harbor, while industry groups argued that a safe harbor was essential to ensure access to credit. The CFPB opted to split the baby: For higher-priced mortgages, satisfying the QM definition operates only as a rebuttable presumption; for all other mortgages, satisfying the QM criteria provides a safe harbor.

Consumers may rebut the presumption by showing that they were left with "insufficient residual income or assets . . . to meet living expenses." Examples of living expenses include "food, clothing, gasoline, and health care, including the payment of recurring medical expenses of which the creditor was aware."

For the safe harbor and other purposes, the CFPB has defined higher-priced mortgages as at least 1.5% above the Average Prime Offer Rate ("APOR") for comparable transactions for first liens, or at least 3.5% above APOR for subordinate liens. Dodd-Frank requires the CFPB to publish the APOR, which varies for different types of mortgages, at least weekly.

Civil Remedies and Record Retention

Under TILA and the Home Ownership and Equity Protection Act ("HOEPA"), as amended by Dodd-Frank, if a creditor materially violates the ability-to-repay provisions, a consumer may recover special statutory damages equal to the sum of all finance charges and fees, plus actual damages, court costs, and attorneys' fees. Mortgage assignees may also be subject to consumer suits, but can avoid liability by demonstrating by a preponderance of the evidence that a reasonable person exercising ordinary due diligence could not have determined that the mortgage was a higher-priced mortgage.

The statute of limitations for consumer suits is three years from the date of the violation. Further, the special statutory damages, as well as three years of finance charges and fees, may be recovered without regard to the statute of limitations as a recoupment or set-off in a foreclosure action. The new rules also lengthen the required time that creditors must retain records to prove compliance with the ability-to-repay and prepayment-penalty provisions from two to three years.

Related Regulations

In addition to these final rules, the CFPB has issued or will issue several other regulations (either independently or jointly with other agencies) related to the mortgage-credit provisions of Dodd-Frank. The agency has announced January 10, 2014 as the "baseline effective date" for these regulations. In the final rules, the CFPB sought public comment on its proposal to relax the new rules for the benefit of the GSEs, federal agencies, and small-portfolio creditors. The CFPB also sought comment on a proposal to permit small creditors to charge 3.5% above APOR while still qualifying for the safe harbor. The CFPB has indicated it expects to finalize this proposal this spring.

Section 15G of the Securities Exchange Act, added by Dodd-Frank, requires a securitizer of asset-backed securities to retain at least 5% of the credit risk of the collateralized assets unless all of the assets are "qualified residential mortgages." Under Dodd-Frank, qualified residential mortgages is jointly defined by six agencies, but in no event may the definition be "broader than" that of a qualified mortgage. Thus, CFPB's qualified-mortgage rules will set the outer boundary for Dodd-Frank's skin-in-the-game requirement. Although the definition of a qualified residential mortgage has yet to be finalized, the August 29, 2011 proposal includes several criteria not included in the CFPB's qualified mortgage definition, including a front-end debt-to-income ratio, a maximum loan-to-value ratio, and a minimum down-payment percentage.

Conclusion

The new rules are the most significant regulations issued to date by the CFPB, the agency created by Dodd-Frank to oversee the federal consumer financial laws. In the final rules, the CFPB acknowledged the "fragile" state of the mortgage market to explain its decision not to publish stricter regulations or to announce an earlier effective date. That said, the long-term effects of these new rules, and the other related regulations, on the mortgage industry remain uncertain. In particular, the new liabilities imposed on creditors under the final rules may well influence the availability of consumer credit, including non-qualified mortgages or higher-priced qualified mortgages, going forward.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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