ABILITY-TO-REPAY:

THE BASICS AND A CHART

Author: Jonathan Foxx

MAGAZINE ARTICLE

THE BASICS

On May 11, 2011, the Federal Reserve Board (FRB) issued a proposed rule (Rule) to implement ability-to-repay requirements for closed-end residential loans.[1] The Rule implements Section 1411, Section 1412, and part of Section 1414 of the Dodd-Frank Wall Street Reform and Consumer Financial Protection Act of 2010 (Dodd-Frank).[2] Comments on the Rule are to be received by no later than July 22, 2011.[3] Having published the proposed Rule, the FRB retired from its involvement in this matter and handed over its rulemaking authority in the subject statute to the Consumer Financial Protection Bureau (CFPB) on July 21, 2011.[4]

As a revision to Regulation Z (the implementing regulation of the Truth in Lending Act), the Rule requires creditors to determine a consumer's ability to repay a mortgage **before** making the loan and would also establish minimum mortgage underwriting standards. The Rule applies to any consumer credit transaction secured by a dwelling, except an open-end credit plan, timeshare plan, reverse mortgage, or temporary loan or ''bridge'' loan with a term of 12 months or less. [5] It appears that the Rule applies to purchase money and refinances, but not modifications of existing mortgages. There is a prohibition on prepayment penalties unless the mortgage is a prime, fixed rate, qualified mortgage - and unless the amount of the prepayment penalty is limited.

The Rule sets forth **limits on prepayment penalties**, the **lengthening of the time creditors must retain records** evidencing compliance with the ability-to-repay and prepayment penalty provisions, a **prohibition to evading the Rule** by structuring a closed-end extension of credit as an open-end plan, the delineation of **new terms, procedures, and their resulting implications**, and, very importantly, the means by which the Rule claims to offer **tools to prevent likely default** and mitigate risk for creditors and others who arrange, negotiate, or obtain an extension of mortgage credit for a consumer in return for compensation or other monetary gain.

Complying with the requirements of the ability-to-repay Rule is essential, because borrowers in a foreclosure proceeding will likely claim that the creditor failed to comply with the Rule as a defense by way of recoupment or set off, without regard to the normal statute of limitations under the Truth-in-Lending Act (TILA).[6] A violation of the Rule subjects the creditor to the TILA civil monetary penalties, plus the same enhanced civil remedies that apply to violations of TILA's high-cost loan rules,[7] and TILA also would authorize state attorneys general to bring actions for violations of the Rule for a period of up to three years.[8]

A loan that is a covered transaction must qualify, among other things, as a **"qualified mortgage"** if the creditor wishes to include a prepayment penalty in the loan.

The Rule provides a <u>presumption of compliance</u> with the ability-to-repay requirements if the mortgage loan is a ''qualified mortgage,'' which does not contain certain risky features and limits points and fees on the loan.

Furthermore, one feature of a higher-risk mortgage loan (i.e., subject to enhanced appraisal requirements under Dodd-Frank § 1471) is the loan may not be a qualified mortgage.[9]

There are **four (4) options** to the determination of compliance with the Rule. The Rule refers to these origination options as "methods" and equips each method with a description of (1) limits on the loan features or term, (2) limits on points and fees, (3) underwriting requirements, and (4) payment calculations.

OPTION # 1: GENERAL ABILITY-TO-REPAY STANDARD

A creditor can meet the general ability-to-repay standard or test by:

- Considering and verifying the following **eight (8) underwriting factors**:

    1. Income or assets relied upon in making the ability-to-repay determination;
    2. Current employment status;
    3. The monthly payment on the mortgage;
    4. The monthly payment on any simultaneous mortgage;
    5. The monthly payment for mortgage-related obligations;
    6. Current debt obligations;
    7. The monthly debt-to-income ratio, or residual income; and
    8. Credit history.

- Underwriting the payment for an adjustable-rate mortgage based on the fully indexed rate.

Comment: This is an option that will be carefully reviewed by plaintiff's counsel in an action to challenge a creditor's compliance with the Rule. Consequently, enforcing compliance with the Rule will require fully vetted, tested, and continually updated, written procedures to govern every aspect of the application and underwriting process. Without clear and unambiguous policies and internal enforcement of appropriate policies and procedures, the creditor is allowing exposure to such a challenge. This option contains rigorous underwriting criteria and requires unmitigated, fact-based evaluations. Option # 1- the **ability-to-repay test** - is somewhat unstable (due to the invariant rigors of procedural compliance) though a relatively favorable methodology for the creditor, even if the loan flow process leaves very little room for error.

OPTION # 2: QUALIFIED MORTGAGE (QM)

A creditor can originate a "qualified mortgage," which provides special protection from liability. Two alternative definitions of a "qualified mortgage" are being considered by the CFPB:

Alternative # 1: Provides a <u>legal safe harbor</u> and defines a "qualified mortgage" as a mortgage for which:

- The loan does not contain negative amortization, interest-only payments, or a balloon payment, or a loan term exceeding 30 years;
- The total points and fees do not exceed three (3%) percent of the total loan amount;
- The income or assets relied upon in making the ability-to-repay determination are considered and verified;[10] and,
- The underwriting of the mortgage (a) is based on the maximum interest rate that may apply in the first five years, (b) uses a payment scheduled that fully amortizes the loan over the loan term, and (c) takes into account any mortgage-related obligations.

Alternative # 2: Provides a rebuttable presumption of compliance and would define a "qualified mortgage" as including the criteria listed under Alternative # 1 (above) as well as additional underwriting requirements from the general ability-to-repay standard (see Option # 1). In any event, under Alternative # 2, the creditor would also have to consider and verify:

- The consumer's employment status;
- The monthly payment for any simultaneous mortgage;
- The consumer's current debt obligations;
- The monthly debt-to-income ratio or residual income; and
- The consumer's credit history.

Comment: Two alternatives are given: in Alternative # 1, to obtain a **legal safe harbor**, the creditor must consider and verify the borrower's current or reasonably expected income or assets to determine the borrower's repayment ability; and, in Alternative # 2, to obtain a rebuttable **presumption of compliance**, the creditor must consider and verify the borrower's current or reasonably expected income or assets (i.e., other than the value of the dwelling in question), the borrower's current employment status (assuming the creditor relies on employment income), the borrower's monthly payment on any simultaneous loan, the borrower's current debt obligations, the borrower's monthly DTI or residual income, and the borrower's credit history. It should be noted that the second alternative is for the most part similar to the ability-to-repay test.

There are some important aspects of Option # 2 that should be considered. With the safe harbor alternative, the Rule would provide that a QM will be **deemed to have complied** with the ability-to-repay test; therefore, the only way that the borrower can get past the safe harbor is by proving that the loan is not a QM. If this occurs, the burden will shift to the creditor or assignee to demonstrate that the loan meets the ability-to-repay test. With the presumption of compliance alternative, the Rule would provide that a QM is **presumed to have complied** with the ability-to-repay test; which means that, even if the mortgage is a QM, the borrower can rebut the presumption of compliance with evidence that the mortgage did not meet the ability-to-repay test. Part of the basis of the proposal is to determine, through public comments, which conditions should apply, either the safe harbor or the presumption of compliance.

Creditors and similarly situated entities would probably favor the safe harbor approach because of the protection from liability that it will afford. On the other hand, consumer advocacy groups and plaintiff's bar will favor the presumption of compliance, because that offers the opportunity to challenge the ability-to-repay for any mortgage, particularly those in imminent foreclosure.

OPTION # 3: BALLOON-PAYMENT QUALIFIED MORTGAGE

This option is obviously meant to preserve access to credit for consumers located in rural or under-served areas where creditors may originate balloon loans to hedge against interest rate risk for loans held in a portfolio.

Under this option, a creditor may make a balloon-payment qualified mortgage with a loan term of five (5) years or more by:

- Complying with the requirements for a qualified mortgage; and
- Underwriting the mortgage based on the scheduled payment, except for the balloon payment.

Comment: This option is meant to preserve access to credit for consumers located in rural or under-served areas.[11] This kind of QM is a loan that generally qualifies as a QM but also includes a balloon payment. The creditor is permitted to underwrite a balloon loan using the maximum payment scheduled during the first five years after consummation. This approach would not capture the balloon payment for a balloon loan with a term of five years or more.[12] This option is subject to certain requirements to which all QMs are subject; for instance, there must be regular periodic payments that do not result in an increase in the principal balance, the loan term may not exceed 30 years, the total points and fees may not exceed the permitted percentage of the total loan amount, and the loan must satisfy the same underwriting and verification requirements.

OPTION # 4: REFINANCING OF A NON-STANDARD MORTGAGE

A creditor may refinance a "non-standard mortgage" with "risky" features into a more stable "standard mortgage." It has been asserted that this option is meant to preserve a consumer's access to a streamlined refinance that "materially" lowers the mortgage payment.

Under this option, a creditor complies by:

- Refinancing the consumer into a "standard mortgage" that has limits on loan fees and that does not contain certain features such as negative amortization, interest-only payments, or a balloon payment;
- Considering and verifying the underwriting factors listed in the general ability-to-repay standard, except the requirement to consider and verify the consumer's income or assets; and
- Underwriting the "standard mortgage" based on the maximum interest rate that can apply in the first five years.

A **non-standard mortgage** is a covered transaction that is an ARM with an introductory fixed rate for a period of one year or more (i.e., a 2/28 ARM), an interest-only loan, or a negative amortization loan. Dodd-Frank refers to a "hybrid mortgage," but the Rule uses the term "non-standard mortgage."

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. Essentially, the standard mortgage structure provides regular periodic payments that do not cause the principal balance to increase,[13] does not allow the borrower to defer repayment of principal, and does not result in a balloon payment; the total points and fees do not exceed the permitted percentage of the total loan amount (see above: Alternative 1 or Alternative 2); the loan term does not exceed 40 years; the interest rate is fixed for at least five years after consummation (this includes step-rate mortgages without a variable rate feature); and, the loan proceeds are used solely to pay off the outstanding principal balance on the non-standard mortgage and closing costs (including escrow amounts).

Option # 4 is available when (1) a non-standard mortgage is refinanced into a standard mortgage, and (2) the following conditions are met:

(1) the creditor for the standard mortgage is the current holder or servicer of the non-standard mortgage;
(2) the monthly payment on the standard mortgage is **materially lower** than the monthly payment on the non-standard mortgage; [14]
(3) the creditor receives the borrower's written application for the standard mortgage before the non-standard mortgage is recast;
(4) the borrower has no more than one payment more than 30 days late on the non-standard mortgage in the 24 months before the creditor receives the borrower's written application for the standard mortgage;

(5) the borrower has no payments more than 30 days late in the six months immediately before the creditor receives the borrower's written application for the standard mortgage;
(6) the creditor has considered whether the borrower is likely to default (a lower standard than "imminent default") on the non-standard mortgage once it is recast; and,
(7) the creditor has considered whether the standard mortgage will prevent the borrower's default.

COMMENT: The Rule introduces a new term to replace a term that has been in use for ARM adjustments for many years. Specifically, for adjustable-rate mortgages with low, fixed introductory rates, the term ''reset'' has typically meant the time at which a low teaser rate converts to a fully indexed rate, resulting in significantly higher monthly payments for homeowners. According to the Rule, the term **''recast''** is henceforth to be used in reference to the time at which fully amortizing payments are required for interest-only and negative amortization loans, on the basis that the term ''reset'' is more frequently used to indicate the time at which adjustable-rate mortgages with an introductory fixed rate convert to a variable rate.[15] Consequently, the Rule uses the term "recast" to cover the conversion to less favorable terms and higher payments not only for interest-only loans and negative amortization loans but also for adjustable-rate mortgages. [16]

OTHER PROVISIONS

There are other provisions incorporated into the Rule,[17] such as:

- Implementing the Dodd-Frank Act's limits on **prepayment penalties**.
- **Lengthening the time creditors must retain records** that evidence compliance with the ability-to-repay and prepayment penalty provisions.
- **Prohibiting evasion of the Rule** by structuring a closed-end extension of credit as an open-end plan.

POINTS AND FEES

Embedded in the QM requirements is a test for **Points and Fees**, the purpose of which is to determine what does or does not constitute a QM. The Rule would limit the total points and fees to a specific percentage of the total loan amount in order to create a threshold to identify a QM.

LOAN ORIGINATOR COMPENSATION AND THIRD-PARTY CHARGES

As it relates to the QM points and fees test, the following should be noted regarding the role played by the recent revisions to TILA with respect to loan originator compensation.[18] **Compensation to loan originators is included in the points and fees.** However, compensation to a loan originator that cannot be attributed to a particular loan at the time of origination is not included in the points and fees. Examples of excluded compensation are compensation based upon the long-time performance of the loan originator, compensation based on the overall quality of the loan originator's loan files, and the base salary of a loan originator who is the employee of the creditor.

THE CHART

SEE ATTACHED

[1] Federal Register, Vol. 76, No. 91, Wednesday, May 11, 2011, Proposed Rules, 12 CFR Part 226, Regulation Z - Truth in Lending Act. [Regulation Z; Docket No. R–1417]

[2] H.R. 4173: *Dodd-Frank Wall Street Reform and Consumer Protection Act*, 111th Congress (2009-2010): "A bill to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end "too big to fail", to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes." Sponsored by Representative Barney Frank (D-MA) and Senator Christopher Dodd (D-CT)

[3] It is worth noting that the Consumer Financial Protection Bureau (CFPB) received rulemaking and examination authority over the "enumerated laws" on the transfer date of July 21, 2011, the Designated Transfer Date. See *Designated Transfer Date*, Bureau of Consumer Financial Protection, Federal Register, Vol. 75, No. 181 (09/20/10). Accordingly, this rulemaking will become a proposal of the CFPB and will not be finalized by the FRB.

[4] For a detailed analysis of the Ability-to-Repay rule, see Foxx, Jonathan, *Ability-to-Repay: Regulating or Underwriting (Part I)*, National Mortgage Professional Magazine, June 2011, Volume 3, Issue 6, pp 26-30; and, Foxx, Jonathan, *Ability-to-Repay: Regulating or Underwriting (Part II)*, National Mortgage Professional Magazine, July 2011, Volume 3, Issue 7, pp 20-42

[5] Also, includes a closed-end home improvement loan on a vacation residence.

[6] Op. cit. 2 § 1413

[7] Under the Home Ownership and Equity Protection Act (HOEPA), a consumer has a right to rescind a transaction for up to three years after consummation when the mortgage contains a provision prohibited by a rule adopted under the authority of TILA § 129(l)(2). Any consumer who has the right to rescind a transaction may rescind the transaction as against any assignee. See: TILA §131(c). The right of rescission does not extend, however, to home purchase loans, construction loans, or certain refinancing with the same creditor. See: TILA § 125(e).

[8] Op. cit. 2, §§ 1416, 1422

[9] Mortgages covered by the HOEPA amendments have been referred to as ''HOEPA loans,'' ''Section 32 loans,'' or ''high-cost mortgages.'' The Dodd-Frank Act now refers to these loans as ''high-cost mortgages."

[10] Does not define a ''qualified mortgage'' to include a requirement to consider the consumer's debt-to-income ratio or residual income.

[11] A county is "rural" if it is not in a metropolitan statistical area (MSA) (or a micropolitan statistical area), contains no town with 2,500 or more residents, and is (a) either not adjacent to any metropolitan statistical area (or a micropolitan statistical area) or (b) is adjacent to an MSA with fewer than one million residents (or adjacent to a micropolitan statistical area).

[12] TILA § 129D(d) authorizes an exemption from escrow requirements for certain creditors operating predominantly in rural or underserved areas and providing an exemption from escrow requirements for transactions secured by shares in a cooperative.

[13] The safe harbor offered requires that a 10% or larger reduction in the monthly payment will meet the "materially lower" standard in reducing monthly payments.

[14] Op. cit. 13

[15] The term "recast" is to be used in order to accommodate the proposed Regulation Z §§ 226.43(c) and (d)

[16] For instance, an ARM *recasts* upon the expiration of the period during which payments based on the introductory fixed rate are permitted. An interest-only loan *recasts* upon the expiration of the period during which interest-only payments are permitted. A negative amortization loan *recasts* upon the expiration of the period during which negatively amortizing payments are permitted.

[17] Op. cit. 4, Part II, *inter alia*

[18] Regulation Z § 226.36(a)