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April 2013 Banking and Mortgage Regulatory Update

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Our January 2013 Update provided information regarding the recently defined Qualified Mortgage and Ability to Repay Rule. On April 10, the Consumer Financial Protection Bureau ("CFPB") distributed a "Small Entity Compliance Guide for the Qualified Mortgage and Ability to Repay Rule," which condensed the official rule and commentary into a more precise and practical tool, while also providing tips for implementing the new rules.

This regulatory update will cover the recently released Small Entity Compliance Guide, and more specifically, the Guide's summation of the Ability to Repay Rule. The Ability to Repay Rule has a broad spectrum that will affect lenders and secondary market participants. Although its name might appear to limit the Guide's applicability, the general principals contained in the Guide and in this update can provide assistance to entities of all sizes that originate closed-end residential mortgage loans.

Applicability

The Ability to Repay Rule applies to almost all closed-end consumer credit transactions secured by a dwelling and any property attached to the dwelling. This includes 1-to-4 unit properties, such as condominiums and co-ops. The Rule is not limited to first liens or to loans only covering primary residences, meaning that second liens are included in the Rule, as well as second homes.

The Rule does not apply to open-end credit plans (such as home equity lines of credit), time-share plans, reverse mortgages, temporary or bridge loans with terms of 12 months or less, consumer credit transactions secured by vacant land, and a construction phase of 12 months or less of a construction-to-permanent loan. Furthermore, if a loan modification is not subject to the Truth in Lending Act, it is not subject to the Ability to Repay Rule.

Compliance

In order to prove compliance with the Rule, affected entities are required to retain evidence of compliance, including the prepayment penalty limitations, for three years after consummation. The standard under the Ability to Repay Rule is that before originating a covered mortgage loan, entities must make a reasonable, good-faith determination that the consumer has a reasonable ability to repay the loan. A reasonable, good-faith attempt includes these eight underwriting factors:

1. Credit history;
2. Current employment status;
3. Current income or assets;
4. Monthly payment for the loan;
5. Monthly payments on other loans related to the property;
6. Monthly cost of other mortgage-related obligations;
7. Other debts owed by the borrower;
8. Monthly debt-to-income ratio (generally must be below 43%).

While your company may already employ these factors, the CFPB recommends reviewing your policies and procedures to ensure that they comply with the Ability to Repay Rule. Furthermore, the CFPB recommends documenting how your company considers each factor, although validation of the underwriting criteria using mathematical models is not required under the Rule. An entity can also employ more than the eight listed factors, but at a minimum, it must consider each of the eight factors.

Verifying Third-Party Information

To verify a consumer's financial information, your company must rely on reasonably reliable third-party records. Verifying this information includes being able to accurately reproduce the forms obtained. If your company does not currently retain such documentation in either paper or electronic form, instituting this practice is essential to obtain compliance with the Rule. Reasonably reliable third-party records include, but are not limited to the following:

- Records from governmental organizations such as a tax authority or local government;
- Federal state, or local government agency letters detailing a consumer's income, benefits or entitlements;
- Credit reports;
- Statements from student loans, auto loans, credit cards or existing mortgages;
- Military leave and earning statements;
- Check-cashing receipts;
- Bank statements, investment account statements.

In order to avoid an unreasonable determination that a consumer was able to repay the loan (and thus, be in violation of the Ability to Repay Rule), your company should avoid employing underwriting standards that are inconsistently applied or fundamentally different for similar loans without providing reasonable justification. Furthermore, considering the consumer's repayment ability post-consummation (*e.g.*, the consumer plans to retire after consummation with no plans for future employment) is evidence of a good faith and reasonable determination of a consumer's ability to repay.

A company would not be in violation of the Ability to Repay Rule if, after completing a reasonable, good faith determination of a consumer's ability to repay the loan, the consumer nonetheless has difficulty or an inability to repay. Determining if your company completed a reasonable, good faith effort is based on information known at or before consummation of the loan. If a consumer can prove in court that your company did not make a reasonable, good faith effort, your company could be liable for, among other things, up to three years of finance charges and fees the consumer paid as well as the consumer's attorney's fees. There is a three year statute of limitations during which Ability to Repay claims can be brought. After the first three years, consumers can only bring claims as setoff/recoupment defenses to foreclosure. This is yet another reason (along with CFPB audits) that sufficient record-keeping and diligence in determining a consumer's ability to repay their loan is employed by your company in the Dodd-Frank era.

This update is not to be considered an offering of legal advice and does not constitute an attorney-client relationship. If you are interested in a more specific and tailored analysis of the compliance-related issues associated with the Dodd-Frank Act, and how it affects your business, please contact Arnold Shokouhi at 214.741.2662.