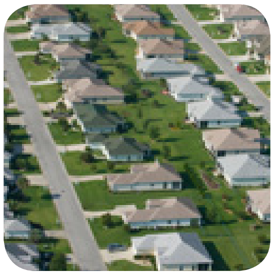
CHAPMAN AND CUTLER LLP

To the Point!

legal, operations, and strategy briefs for financial institutions January 24, 2013



Special Edition: Ability-to-Repay and Qualified Mortgage Standards Rule

The Consumer Financial Protection Bureau's (the *"Bureau"* or *"CFPB"*) new Ability-to-Repay and Qualified Mortgage Standards Rule (the *"Rule"*) is lengthy and complicated. It is not a disclosure rule but instead requires a creditor to revise loan products and its origination and underwriting practices, including compensation to its employees and third party loan originators. Following is a summary of significant parts of the Rule. The Rule provides compliance options, each which should be analyzed based on the creditor's customers and its operational capabilities.

Ability-to-Repay Requirement

Under the Rule, at or before consummation, a creditor is required to make a reasonable, good faith determination of a consumer's ability-to-repay, according to its terms, any credit transaction secured by a dwelling (excluding an open-end plan, timeshare, reverse mortgage or temporary loan). Generally, the Rule provides four (4) methods to meet this ability-to-repay requirement:

I. Originating loan after considering and verifying eight (8) factors through creditor's underwriting standards.
II. Originating a "Qualified Mortgage".
III. Originating rural balloon-payment Qualified Mortgage.
IV. Refinancing a "non-standard mortgage" into a "standard mortgage".

Substantial penalties may apply if a creditor fails to meet ability-to-repay standards for a loan, including actual damages (which could include the borrower's downpayment), statutory damages up to $4,000, all fees paid by the borrower, up to three (3) years of finance charges paid by the borrower, and court costs and reasonable attorney's fees.

This Rule will take effect on January 10, 2014.

I. Eight Underwriting Factors

Under method I above, a creditor can meet the ability-to-repay requirement through its determination based on verification and evaluation of the following eight (8) factors regarding the consumer and the proposed loan:

1. current or reasonably expected income or assets, other than the value of the dwelling;
2. current employment status, if the creditor relies on employment income;
3. monthly payment on the transaction, calculated based on the greater of the fully indexed rate or any introductory rate;
4. monthly payment on any simultaneous loan the creditor knows or should have known about, such as a home equity line of credit made to the same consumer at or before consummation of the transaction and secured by the same dwelling;
5. monthly payment for mortgage-related obligations, such as expected property taxes;
6. current debt obligations, alimony, and child support;

7. monthly debt-to-income ratio or residual income; and
8. credit history.

The Bureau intended to maintain flexibility in the Rule and stated it is not mandating a creditor's underwriting standards, however, a creditor must consider each of the factors outlined above to satisfy the ability-to-repay requirement. The Bureau notes that creditors are permitted to develop and apply their own proprietary underwriting standards and to make changes to those standards over time based on empirical information and changing economic and other conditions. It is important to note that in determining whether the ability-to-repay requirement is met, a creditor is not permitted to make inquiries or verifications prohibited by the Equal Credit Opportunity Act.

The Rule provides detailed guidance in its commentary on the general requirement of ability-to-repay and the factors for making that determination. Creditors may also look at guidance issued by federal agencies, such as the Federal Housing Administration, U.S. Department of Veterans Affairs, the U.S. Department of Agricultural, or Fannie Mae or Freddie Mac.

If a creditor chooses to meet the ability-to-repay requirement through its own determination based on the eight (8) factors outlined above, the creditor must review and revise its underwriting policies and procedures to ensure it obtains the information necessary and analyzes each factor to comply with the ability-to-repay requirement. Under the Rule, creditors are required to keep records of their compliance with the ability-to-repay requirements for three (3) years.

II. Qualified Mortgage

As noted in method II above, if a creditor makes a Qualified Mortgage it is presumed to have complied with the ability-to-repay requirement. The Qualified Mortgage standard contains limitations on loan terms which Congress believes contributed to consumers having mortgages they could not afford, resulting in high default and foreclosure rates. The following criteria apply to a determination of whether a mortgage is a Qualified Mortgage under the Rule.

A Qualified Mortgage must:

- provide regular periodic payments; and
- be underwritten by:
  (i) taking into account (a) the monthly payment for mortgage related obligations using the maximum interest rate that may apply during the first five (5) years and (b) periodic payments of principal and interest based on such interest;
  (ii) considering and verifying (a) consumer's current or reasonably expected income and assets; and (b) current debt obligations, alimony, and child support; and
  (iii) requiring that a consumer's debt-to-income ratio does not exceed 43%.

A Qualified Mortgage cannot have:

- negative amortization, interest-only or balloon features (subject to certain exceptions);
- a loan term exceeding 30 years;
- points and fees exceeding specified thresholds (3% of the total loan amount for loans $100,000 and greater) (see discussion below); or
- a prepayment penalty (subject to certain exceptions) (see discussion below).

The Rule offers a temporary, alternative method to establish that a loan is an eligible Qualified Mortgage. The temporary rule expires on the earlier of the effective date of a qualified mortgage rule that is issued by the agencies below or January 10, 2021.

The loan must:

- provide regular periodic payments; and
- be eligible for (i) purchase or guarantee by Fannie Mae or Freddie Mac under conservatorship or a limited-life regulatory entity successor to either; (ii) insurance by HUD/FHA or the Rural Housing Service; or (iii) VA or Department of Agriculture guarantee.

The loan cannot have:

- a loan term exceeding 30 years; or
- points and fees exceeding specified thresholds (3% of the total loan amount for loans $100,000 and greater) (see discussion below).

After establishing that a loan is a Qualified Mortgage, the creditor is provided a safe harbor for compliance with the ability-to-repay requirement if the Qualified Mortgage has an annual percentage rate (*"APR"*) that does not exceed the Average Prime Offer Rate (*"APOR"*) by 1.5 or more percentage points for a first lien mortgage or 3.5 percentage points for a subordinate lien transaction (a *"prime loan"*). If the APR for a Qualified Mortgage exceeds these limits (a *"subprime loan")*, the creditor will be provided a presumption of compliance with the ability-to-repay requirement that can be rebutted by the consumer. The Rule contains the grounds that can be used by the consumer to rebut the presumption that the creditor determined that the consumer had the ability-to-repay the mortgage.

Consumers can challenge the status of the mortgage as a Qualified Mortgage for three (3) years in a direct cause of action and at any time in a foreclosure action. As noted above, under the Rule, creditors are required to keep records of their compliance with the ability-to-repay requirements for three (3) years; however, due to the consumer's ability to challenge the status of the loan as a Qualified Mortgage in a foreclosure action, we recommend that records be retained until the loan is paid.

Qualified Mortgage Limitation on Points and Fees

The Rule places limitations on permitted points and fees charged in connection with a mortgage for the loan to be deemed a Qualified Mortgage as defined under the Rule. The amount of points and fees permitted is based on the total loan amount with most loans (those $100,000 and greater) limited to 3% of the total loan amount. Loan amounts under $100,000 are tiered and each tier is subject to a different limit.

The calculation of the points and fees to establish whether a loan is a Qualified Mortgage will not be disclosed to the consumer, but is critically important to the creditor. To ensure a mortgage loan is a Qualified Mortgage eligible for certain protections from liability under the Rule, will require a review of all aspects of the loan origination process and possible changes to vendors, vendor compensation, and compensation of employees.

Points and fees are defined in the Rule, however, creditors must be cautious and review each part of the Rule carefully when determining whether a particular charge is included in or excluded from the calculation of points and fees. An item excluded from the calculation of points and fees under one part of the Rule may be includable through the application of another part of the Rule. The Bureau has adopted the general rule that more specific provisions of the Rule that include a particular item in the calculation of points and fees will take precedence over more general exclusions.

Points and Fees Summary	
Included	***Excluded***
• Finance charges under Regulation Z 1026.4 • Points and fees charged at closing and known at or before closing • Amounts directly or indirectly paid by the creditor or the consumer to a loan originator • Prepayment penalties • Private mortgage insurance premiums payable at or before closing are partially included • Premiums for credit insurance, debt cancellation or suspension coverage and life, accident, health or loss-of-income insurance (if the creditor is a beneficiary) payable at closing • Real estate related charges listed in Regulation Z 1026.4(c)(7) (subject to limitations)	• Interest • Loan modification fees • Premiums for private mortgage insurance payable after closing • Premium and guaranty fees related to federal and state government programs, whenever paid • Premiums for credit insurance payable after closing • Bona fide discount points excluded (subject to limitations) • Tax escrows • Real estate related charges listed in Regulation Z 1026.4(c)(1) if charge is reasonable, creditor receives no direct or indirect compensation and charge is not payable to an affiliate of creditor

Certain fees imposed in connection with the transaction that are known at or before closing but paid later are included in the points and fees calculation. For example, fees included in the loan amount and financed by the consumer and prepayment penalties are included in the points and fees calculation. The maximum prepayment penalty that can be charged under the loan is included in the calculation of points and fees. On the other hand, loan modification fees and premiums for private mortgage insurance and credit insurance payable after closing are not included in the points and fee calculation.

Certain mortgage insurance premiums are excludable from the calculation of points, but fees and portions of other mortgage insurance premiums are includable. Both premiums and guaranty fees in connection with Federal or State government programs are excludable whenever paid. Private mortgage insurance premiums paid after closing are excluded from the calculation of points and fees. Private mortgage insurance premiums payable at or before closing are partially excluded. The portion of the premium not in excess of the FHA premium is excluded (subject to refund requirements), while the portion of the premium in excess of the FHA premium is included in the calculation of points and fees. This partial exclusion is available even if the mortgage loan is not eligible to be an FHA loan (principal balance is too high).

Bona fide discount points are excludable from the calculation of points and fees based on the pre-discount loan rate. If the pre-discount rate is not more than one percentage (1%) point over the APOR, then two (2) bona fide discount points are excludable, and if the pre-discount rate is not more than two percentage (2%) points over the APOR, then one (1) bona fide discount point is excludable.

The Rule includes in the calculation of points and fees amounts *directly or indirectly paid by the creditor or the consumer* to a loan originator. Points and fees include compensation paid by the creditor to individual loan officers of the creditor and brokers, and to brokerage firms themselves in connection with the transaction. Creditors will be required to track employee compensation for the purpose of complying with the Rule. Loan originator compensation, whether paid before or after closing, is includable if it can be attributed to that particular transaction at the time the interest rate is set. It does not include the loan originator's base salary or compensation such as a bonus, commission, an award of merchandise, services, trips or similar prizes if such compensation can not be attributed to the particular transaction.

Certain real estate related charges listed in Regulation Z 1026.4(c)(7) (except amounts held for the future payment of taxes) are included in the calculation of points and fees *unless* the charge is reasonable, the creditor receives no direct or indirect compensation from the charge, and the charge is not paid to an affiliate of the creditor. As a result, if the creditor uses an affiliated appraiser or a title insurance company, those charges will be included in the calculation. This requirement will make it more difficult for creditors using affiliated service providers to meet the applicable points and fee cap.

Premiums for credit insurance, debt cancellation or suspension coverage and life, accident, health or loss-of-income insurance (if the creditor is a beneficiary), payable at closing are included in the calculation of points and fees.

Prepayment Penalties

The Rule prohibits and restricts certain prepayment penalties. Prepayment penalties for (i) adjustable rate prime loans, and (ii) all subprime loans are prohibited. A repayment penalty is allowed for a Qualified Mortgage that is a fixed-rate prime loan if the prepayment penalty:

1. is permitted under applicable law;
2. applies no longer than three years from loan origination; and
3. is no greater than 2% of balance prepaid during the first two (2) years and 1% of balance prepaid during the third year.

In addition, if the creditor offers the consumer a loan product with a prepayment penalty, the creditor must also offer the consumer a substantially similar non-prepayment penalty loan product for which the consumer is likely to qualify. Similarly, a creditor that uses a mortgage broker to offer its loan products with a prepayment penalty must also offer a non-prepayment loan product to the loan broker and must establish an agreement with the loan broker requiring the loan broker to offer the non-prepayment product to the consumer.

The maximum prepayment penalty that can be charged under the loan product is included in the calculation of points and fees used to determine whether the loan is a Qualified Mortgage.

To establish compliance with the Rule, we recommend that each creditor initially review all of its loan products to determine which, if any, contain prepayment penalties. If a creditor determines it has a loan product(s) with a prepayment penalty, the creditor should implement the following steps, as appropriate: change the terms of loan product(s) to become compliant with the Rule or remove prepayment penalties features; change policies and procedures related to loan origination such that meaningful alternatives without prepayment penalties are offered; change loan broker agreements; begin to audit loan brokers to establish that a non-prepayment penalty loan product is offered if a prepayment penalty loan product is offered; and institute a procedure to obtain acknowledgement from a consumer who receives a prepayment penalty loan product that the consumer was also offered a non-prepayment penalty loan product.

III. Originating Rural Balloon-Payment Qualified Mortgage

A creditor making loans in predominantly rural or underserved areas can include a balloon payment feature in its loans, *provided*, the loans meet the other requirements for a Qualified Mortgage. The creditor must also meet certain size requirements and additional limitations apply to the loan terms.

IV. Refinancing a "Non-Standard Mortgage" Into a "Standard Mortgage"

A creditor who refinances its "non-standard loan" to a "standard loan" may be exempt from the ability-to-repay requirement. The Rule defines both a non-standard and standard loan and includes the following additional requirements on this exception: (i) creditor for standard mortgage is holder of existing non-standard mortgage; (ii) monthly payment is materially lower than payment on non-standard mortgage; (iii) creditor receives consumer's written application for the standard mortgage no later than two (2) months after the non-standard mortgage has recast; and (iv) consumer has made no more than one (1) payment thirty (30) days late on the non-standard mortgage during the last twelve (12) months before application and not within the last six (6) months. The Rule also includes calculations to determine if the consumer has the ability-to-repay the standard loan.

Chapman and Cutler LLP

Attorneys at Law · Focused on Finance®

To the Point! is a summary of items of interest and current issues for financial institutions with primary focus on regulatory, consumer, and corporate issues. Chapman and Cutler LLP maintains a dedicated practice group with expertise to counsel on these issues and other enterprise risk management matters facing financial institutions. If you would like to discuss any of the items contained in these briefings or other legal, regulatory, or compliance issues facing your institution, please contact one of the partners in our Bank Regulatory Group:

Marc Franson • 312.845.2988
Scott Fryzel • 312.845.3784
Heather Hansche • 312.845.3714
Doug Hoffman • 312.845.3794
John Martin • 312.845.3474
David Worsley • 312.845.3896
Dianne Rist • 312.845.3404

Chapman and Cutler LLP | 312.845.3000 | 111 West Monroe Street | Chicago | IL | 60603