ABILITY-TO-REPAY:

REGULATING OR UNDERWRITING?

PART II

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I leave it to be settled, by whomsoever it may concern,
whether the tendency of this work be
altogether to recommend parental tyranny,
or reward filial disobedience.
Northanger Abbey - Jane Austen

In my previous article in June, I discussed the proposed rule issued by the Federal Reserve Board on May 11, 2011 regarding requirements for the Ability-to-Repay (Rule).[1] The Rule affects closed-end residential loans.

The Federal Reserve Board (FRB) issued this proposed rule (Rule) to implement ability-to-repay requirements for closed-end residential loans. 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.

This month, the FRB will retire from its involvement in this matter, because it is handing over its rulemaking authority in the subject statute to the Consumer Financial Protection Bureau (CFPB) on July 21, 2011. [3]

Thus, the promulgation of the final Rule will be under the aegis of the CFPB.

In Part I of this article series, I explored some of the salient features of this Rule, noting particularly that, as a revision to Regulation Z (the implementing regulation of the Truth in Lending Act), it 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,[4] except an open-end credit plan, timeshare plan, reverse mortgage, or temporary loan or ''bridge'' loan with a term of 12 months or less. 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.

I have discussed also that complying with the requirements of the 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).[5] 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, [6] and TILA also would authorize state attorneys general to bring actions for violations of the Rule for a period of up to three years.[7]

A loan that is a covered transaction must qualify, among other things, as a **"qualified mortgage" (QM)** if the creditor wishes to include a prepayment penalty in the loan. The Rule provides a presumption of compliance 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.[8] 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 QM.[9] (Under Dodd-Frank § 941, a **"qualified residential mortgage"** (QRM) may not be broader in scope than a QM as defined in the Rule.)[10]

In this Part II of the article series, I will examine more closely the eight factors that constitute the ability-to-repay as well as consider many other features of the Rule, including the limits on prepayment penalties, the lengthening of the time creditors must retain records evidencing compliance with the ability-to-repay and prepayment penalty provisions, the 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 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.

PREPAYMENT PENALTIES

Recall that part of 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. Points and fees do not include compensation paid to licensed persons who perform real estate broker services (so long as they are not compensated by a creditor, loan originator, or an agent of either); a servicer or its employees or agents, including those who negotiate loan offers or modifications for delinquent or defaulted loans or those in danger of delinquency or default; and, certain employees of manufactured home retailers.

In the QM points and fees test, *bona fide* third party charges (other than includable mortgage insurance premiums) may be excluded if, and only if, they are not paid to the creditor, a loan originator, or an affiliate of either of them.[11] And, up to two (2) *bona fide* discount points can be excluded if the interest rate before discount does not exceed by more than 1% the APOR[12] for a comparable transaction as of the date the interest rate is set for the discounted interest rate. But, if these discount points have not been excluded, then up to one (1) *bona fide* discount point can be excluded if the interest rate before discount does not exceed by more than 2% of the APOR for a comparable transaction as of the date the interest rate is set for the discounted interest rate.[13]

With that in mind, a "prepayment penalty" means any charge imposed for paying all or any part of a covered transaction's principal **before the date it is due**. But the term is applied broadly to include:

1. Traditional prepayment charges,
2. Any interest that is charged on a loan balance after the date that any part of it is prepaid (i.e., for certain government loans that prepay on other than a payment due date, charging interest on the full balance of the loan through the end of the month), and
3. A closing cost or other fee that is waived unless the borrower prepays the loan.

It should be emphasized that # 2 above affects government loans. [14] A "prepayment penalty" does not include fees for preparing and providing documents when a loan is prepaid in full, whether or not the loan is actually prepaid, such as loan payoff statements, and documents involving reconveyance or release of the lender's security interest.

Importantly, the prepayment is factored into the "total loan amount" calculation so that the included amount will result in a higher percentage than at present. In other word, **the QM points and fees test will for the most part disenfranchise the use of prepayment penalties**.

To understand how the "total loan amount" is calculated, including the prepayment penalties, it is necessary to recognize that this term uses the revised high-cost mortgage rules, as follows:

> Deduct the following items from the Amount Financed (as that term is defined in Regulation Z) to compute the **total loan amount**:
>
> a. All items under Section 226.4(c)(7) of Regulation Z (other than tax escrows) that are payable at or before loan closing, unless the charge is reasonable, the creditor receives no direct or indirect compensation in connection with the charge, and the charge is not paid to an affiliate of the creditor;
>
> b. Premiums payable at or before loan closing for credit insurance or debt cancellation/suspension coverage, whether mandatory or optional; and,
>
> c. The total prepayment penalty incurred if the loan is being refinanced by the current holder or servicer of the existing mortgage or an affiliate of either of them (as long as "a," "b," and "c" are included in the points and fees as well as financed by the lender).

The FRB solicited comments on an alternative, perhaps more facile, calculation of the "total loan amount." [15]

Limitations and Features

1. First, a covered transaction may not include a prepayment penalty unless all of the following conditions are met:

   A. The prepayment penalty must be otherwise permitted by applicable law.

   B. The APR of the loan cannot increase after consummation. [16]

   C. The loan must be a QM or a Balloon Payment Qualified Mortgage (BPQM).

   D. The loan must not be a higher-priced mortgage loan under Section 226.45 of Regulation Z. [17]

2. Secondly, the duration of the prepayment penalty period may not be more than three years after the consummation of the loan.

3. Third, the amount of the prepayment penalty (i) may not exceed 3% of the outstanding, prepaid loan balance if incurred during the first year after consummation of the loan, (ii) may not exceed 2% of the outstanding loan balance prepaid if incurred during the second year after consummation of the loan, and (iii) may not exceed 1% of the outstanding, prepaid loan balance if incurred during the third year after consummation of the loan.

In the QM points and fees test, a loan that includes the aforementioned, maximum prepayment penalties must include 3% of the entire outstanding loan balance as part of the points and fees. Consequently, the creditor and loan originator would have to forego virtually all other points and fees in order to meet the QM test. [18]

Closed-end reverse mortgages, bridge loans with initial terms of 12 months or less, and loans with initial terms of 12 months or less to finance the initial construction of a dwelling are subject to the restrictions on prepayment penalties. Because a closed-end reverse mortgage involves the addition of interest and fees to the principal balance, a reverse mortgage does not qualify as a QM and, therefore, by definition cannot include prepayment penalties.

Conditions – Alternative Loans

Consistent with providing information about alternative financing options to a consumer, if the lender offers a covered transaction that contains a prepayment penalty, it must also offer a covered transaction that does not contain a prepayment penalty (an "alternative loan"). Obviously, if the lender determines that the borrower cannot qualify for any alternative loan, then it should not offer a loan with a prepayment penalty. There is no violation of this Rule relating to alternative loans if the covered transaction is closed without a prepayment penalty or no covered transaction is closed at all. A creditor may not structure what is constructively a covered transaction as an open-end loan in order to evade the requirements of the Rule.

In any event, any such loan, constructively being a covered transaction, would need to comply with the closed-end credit rules, which include the ability-to-repay.

Alternative Loan - Lenders

The **alternative loan** must meet **all** of the following conditions:

1. The APR of the alternative loan must not increase after consummation.

2. The alternative loan must be the same type of loan as the loan with the prepayment penalty.

3. The alternative loan must have the same term as the loan with the prepayment penalty.

4. The alternative loan must provide for regular periodic payments that do not result in an increase in the principal balance (i.e., does not allow the borrower to defer the repayment of principal and does not result in a balloon payment, unless the loan is a BPQM).

5. The alternative loan must have total points and fees that do not exceed the permitted percentage of the total loan amount for a QM (see above) based on information known to the creditor at the time the alternative loan is offered.

6. The lender must have a *good faith* belief that the borrower qualifies for the alternative loan, based on information known to the lender **at the time the alternative loan is offered**. [19]

Alternative Loan - Brokers

If a mortgage broker offers a prepayment penalty, the lender must also present the mortgage broker with an alternative loan that meets the above-mentioned conditions. Operationally, this can be done by the lender providing a rate sheet to the mortgage broker, which includes the terms of the alternative loan. I would advise the lender to execute an agreement with the mortgage broker, requiring the mortgage broker to present an alternative loan to the borrower. [20]

The alternative loan can come from the creditor or from another creditor (if the loan offered by the other creditor has a lower interest rate or lower total dollar amount of origination fees and discount points). Procedurally, this disclosure is methodologically similar to, but does not replace, the anti-steering protocol derived from the final rule of the Truth in Lending Act's loan originator compensation requirements set forth in the revised Regulation Z. [21]

The same requirements apply for table-funded transactions. The creditor must offer an alternative loan that meets the conditions described hereinabove, that is, offered by the assignee or by another creditor (if the loan offered by the other creditor has a lower interest rate or lower total dollar amount of origination fees and discount points).

The Rule mandates retaining records for three (3) years after consummation of the loan. If the creditor must verify and document information used to underwrite a loan, the creditor must retain evidence sufficient to demonstrate compliance with that requirement. Retention of hard copies is not required, as long as the lender can reproduce the documents. Two (2) years after the date that disclosures are required, excluding the record retention provisions relating to advertising rules, remain in place for other provisions of Regulation Z.

FINALE

A story has no beginning or end: arbitrarily one
chooses that moment of experience from which to
look back or from which to look ahead.
The End of the Affair - Graham Greene

The ability-to-repay requirements are set forth in the Federal Register, consisting of 117 pages, in the usual three column format. In long format, as produced by the Federal Reserve itself, the requirements consume 474 pages. This is a very complicated set of guidelines.

Some of the criticism directed at this Rule involves, among other things, the linkage between the qualified mortgage (QM) and the qualified residential mortgage (QRM), and the ostensible imposition of underwriting guidelines in a regulatory framework. The broader issue is the extent to which the Rule actually raises the pricing to the consumer. The Qualified Residential Mortgage (QRM) exemption for risk retention purposes (as required by Section 941of Dodd-Frank) and the Qualified Mortgage (QM) definition (under the "Ability-to-Repay" provisions of Section 1412 of Title XIV of Dodd-Frank) do require further synchronizing.

Recently, the Wall Street Journal described three ways that the standards for the QRM could be improved, such as, (1) by requiring a minimum 20% down payment and an alternate outlining a 10% down payment and mortgage insurance, with loan-to-value ratios could be higher for refinances; or, (2) prescribing steps requiring originators to verify borrowers' incomes; or, (3) providing calculation such that the maximum amount of a borrower's income can go towards mortgage payments (i.e., DTI); or, (4) recommending mortgage debt equal to 28% of income and total debt equal to 36% of income, with the alternative being ratios of 33% and 41% under certain circumstances; or finally, (5) clarifying which types of loans will be ineligible, such as disallowing interest-only mortgages, but allowing certain adjustable-rate loans that could qualify, although the originators would have to ensure that borrowers can make payments if interest rates rise. [22]

Essentially, the gambit being proffered by Dodd-Frank is based on the theory that mortgage securities backed by QRM loans should be exempt from the risk-retention rules, on the theory that investors understand the underwriting quality and risks of these loans sufficiently that additional "skin in the game" is not necessary. QRM, therefore, is directly related to new risk retention requirements. In a forthcoming article, I will treat extensively the QRM and risk retention. For the sake of understanding the ability-to-repay, suffice it to recognize that Dodd-Frank requires mortgage originators and securitizers to keep at least 5% of the credit risk, involving certain types of mortgages, whenever they are involved in creating or selling appertaining, residential mortgage-backed securities. The ability-to-repay links up with the way risk retention is defined because QRMs are deemed to carry a lower risk of default.

However, there is no clear elaboration of possible adverse outcomes to implementing such a scheme. As Mark Zandi and Cristian Deritis, of Moody's Analytics, state:

> "Getting the QRM definition right is vital. Too narrow a definition—limited to loans with very high down payments and high credit scores, for example—could significantly raise the cost of mortgage credit and reduce its availability for a large number of potential borrowers. Too wide a QRM definition could blunt the risk retention rule's ability to raise market confidence in securitization."

In my next article, I will discuss in detail the qualified residential mortgage and risk retention.

But certainly with regards to the ability-to-repay and the QM, imposing a duty upon lenders to assure a borrower's ability to repay as a regulatory requirement, effectively codifying underwriting guidelines - although not without precedent as a legal construct - has become a signal part of Dodd-Frank, thereby enshrining a particularly inherent underwriting feature to a regulatory framework. The extent to which there is a drift toward "subjectivity" regarding what does or does not constitute valid criteria for the ability-to-repay seems to be cast as a regulatory, rather than an underwriting methodology.

How is this approach different from the so-called "plain vanilla" notion which privileged certain forms of standard mortgages (offering safe harbor) over others? Indeed, by defining qualified mortgages to exclude negative-amortizing mortgages, or with certain high balloon payments, Dodd-Frank is effectively privileging the other mortgage structures by according them a rebuttable presumption of demonstrated ability to repay. This seems odd. It is not a complete safe harbor from statutory scrutiny, but an exemption from one of its more significant and transformative requirements. But what is the privilege worth, when the broad definition of the QM provides express criteria for compliance with the regulatory guidelines (i.e., relating to DTI, *mutandis mutandi* a proxy for the ability to repay)?

Put it this way: if a mortgage meets the required ability-to-repay, per the federal regulatory guidelines, there is a rebuttable presumption of compliance that the ability-to-repay has been met. In philosophical logic, this is usually referred to as "circular reasoning." It seems likely that regulators will bring forth ever on-going issuances of new rules, and attendant calculations - *de facto* underwriting guidelines – that will continue to set the then current standard.

Another way to view this is the gradual nationalizing of underwriting guidelines. Furthermore, it seems to me that the imposition of an ability-to-repay requirement as a regulatory mandate is an admission that market forces cannot discipline lenders or incentivize lenders to act in their own self-interest. This is an obvious shift in liabilities, because this mandate shifts the burden of compliance to the lenders in order to assure that their contractually bound borrowers can pay back their loans. Parties to any contract can become adversaries! In other words, the relationship between the creditor and the borrower is innately affected and extensively undermined by this Rule, inasmuch as it imposes a new kind of theory for a regulatory framework and, in my estimation, infantilizes lenders by making them comply with a regulator's *ad hoc* way of rationing the extension of credit.

If the rationing of credit is meted out through this regulatory construct, it can be legitimately asserted as well that lenders are not arms-length, contractual counterparties; that is, lenders now will have a duty to assess a prospective borrower's ability to repay, irrespective of collateral value and securitization. This change in the dynamics between and the inherent, due diligence tension among the parties to a residential mortgage transaction raises serious issues about the systemic consequences soon to be engendered.

[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] July 21, 2011 is the date, pursuant to Dodd-Frank, that the Consumer Financial Protection Bureau (CFPB) receives rulemaking and examination authority over the "enumerated laws," the so-called "Designated Transfer Date." See *Designated Transfer Date*, Bureau of Consumer Financial Protection, Federal Register, Vol. 75, No. 181 (09/20/10). The Designated Transfer Date must be between January 17, 2011 and July 21, 2011, unless the Treasury Secretary determines that the orderly implementation of Title X is not feasible within 12 months; but, in no case may the Designated Transfer Date be later than January 21, 2012.

[4] Includes a closed-end home improvement loan on a vacation residence.

[5] Op. cit. 2 § 1413

[6] 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).

[7] Op. cit. 2, §§ 1416, 1422

[8] Dodd-Frank stipulates that FHA loans are QRMs, because of their explicit government backing. And as long as the GSEs operate under government control, the QRMS are supposed to apply to GSE loan products as well.

[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] The Qualified Residential Mortgage (QRM) exemption for risk retention purposes (as required by Section 941of the DFA) and the Qualified Mortgage (QM) definition (under the “ability to repay” provisions of Section 1412 of Title XIV of Dodd-Frank) require synchronizing.

[11] The FRB has requested comment as to whether loan-level price adjustments to offset added risks, which are imposed by secondary market purchasers and passed through to borrowers in the form of points, should be excluded from the points and fees under this provision.

[12] Required by Dodd-Frank, effective April 1, 2011, if a jumbo loan’s APR exceeds the average prime offer rate (APOR) by 2.5 or more percentage points on the date the interest rate is set, then TILA requires the establishment of an escrow account for the payment of property taxes and any creditor-required premium for mortgage-related insurance, prior to consummation. For jumbo loans with an APR which does not exceed the APOR by 2.5 percentage points or more, this escrow requirement will no longer apply.

[13] To be a *bona fide* discount point, the calculation must both (1) be consistent with established industry practice, and (2) account for the amount of compensation that the creditor can reasonably expect to receive from secondary market investors for the loan.

[14]Government loans require the charging of interest through month-end when the loan is prepaid on other than a payment due date. Because the additional interest is treated as a prepayment penalty, the loan could be treated as unlawful under the Rule if the lender charges a prepayment penalty more than three years after consummation. Moreover, if such a loan is characterized as a loan that includes a prepayment penalty, the lender must offer an alternative loan. (See “alternative loan.”)

[15] The FRB alternative is a calculation that is equal to the principal loan amount, less charges that are points and fees under Section 226.32(b)(1) of Regulation Z, and that are financed by the creditor. Note, however, that the alternative calculation would generally result in a larger total loan mount, thus requiring even more points and fees.

[16] The APR of a fixed-rate mortgage or a step-rate mortgage without a variable rate feature does not increase after consummation.

[17] That is, the “transaction coverage rate” must not exceed the APOR for a comparable transaction as of the date the interest rate is set by more than 1.5% for a first lien loan that does not exceed the Freddie Mac conforming loan limit, by more than 2.5% for a first lien loan that does exceed the Freddie Mac conforming loan limit, or by more than 3.5% for a subordinate lien loan.

[18] The FRB’s prepayment penalty calculation is less generous to the mortgage holder than given in Dodd-Frank, as the former applies the applicable percentage against the outstanding loan balance prepaid, but the latter applies the applicable percentage against the entire outstanding loan balance.

[19] The creditor may rely on information provided by the borrower, even if it is subsequently determined to be inaccurate.

[20] This agreement can be an additional addendum to the existing compensation agreement between the parties to the transaction or a separate agreement relating thereto.

[21] 75 Federal Register 58509, September 24, 2010.

[22] Timiraos, Nick, *Five Questions on the Qualified Residential Mortgage*, Wall Street Journal, WSJ Blog, 3/24/11.