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January 2013 Banking and Mortgage Regulatory Update

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<u>Qualified Mortgages</u>

For many months after the passage of the Dodd-Frank Act, one of the biggest questions left unanswered centered on the definition for a key term within Title XIV: Qualified Mortgage. Lenders obtain valuable legal protections if they issue Qualified Mortgages, so the January 2013 announcement of the definition and features of Qualified Mortgages is a welcome addition to the industry.

Points and Fees

Qualified Mortgages must meet certain requirements, which prohibit or limit the predatory features that contributed to the 2008 collapse. Under the finalized rule, lenders must limit the points and fees passed on to consumers. Including in this limitation are those fees and points used to compensate loan officers and brokers. In general, the points and fees paid by the borrower must not exceed 3% of the total amount borrowed. There are some exceptions for "bona fide discount points" on prime loans, but the 3% limit is significant because Fannie Mae requires points and fees under its program to not exceed 5% of the total loan amount. The Qualified Mortgage 3% points and fees limitation should contribute to a healthier overall industry and protect both consumers and lenders.

Prohibition on "Toxic" Loan Features

"Toxic" loan features are features associated with the types of mortgages that contributed to the financial collapse. They include interest-only loans, negative-amortization loans, most balloon loans, and loans with terms longer than 30 years. There are some exceptions for balloon loans issued by smaller lenders in "rural or underserved" areas, but only if the lenders have less than $2 billion in assets, originate no more than 500 first-lien mortgages per year, and generally must hold the loans on their portfolios for three years. Furthermore, loans that do not required verified asset and income information, or "no-doc" loans will not be considered for Qualified Mortgage status.

Revised Debt-to-Income Standards

Qualified Mortgages will be offered to borrowers whose debt-to-income ratio is no higher than 43%. While some individual borrowers may be able to afford a mortgage while having a debt-to-income ratio higher than 43%, a temporary category of Qualified Mortgages will be offered, provided that they satisfy the general Qualified Mortgage standards and further satisfy the underwriting requirements of, (and are therefore eligible to be purchased, guaranteed, or insured by) either FNMA, FHLMC, HUD, VA, or Department of Agriculture or Rural Housing Service. This second, temporary category will phase out after seven years.

Legal Protections

An added benefit of a theoretically healthier mortgage market will be the legal protections afforded to lenders who create mortgages that adhere to the Qualified Mortgage standards. Depending on the type of Qualified Mortgage generated, lenders will have two different types of legal protection against borrower lawsuits:

- *Safe Harbor*

  Lower-priced loans generally offered to borrowers that are a lower risk to default. If a default occurs, the lender is considered to have legally satisfied the ability-to-repay requirements. Borrowers will still be able to challenge whether the loan meets the definition of a Qualified Mortgage. Furthermore, this safe harbor does not protect lenders against lawsuits based on violations of other federal consumer protection laws.

- *Rebuttable Presumption*

  Higher-priced loans generally offered to borrowers with lower credit scores/credit history. A "Higher-priced" loan refers to a loan with an interest rate that is more than 1.5% higher than the current prime rate. If a default occurs, a borrower can rebut the presumption that the lender considered and adhered to the ability-to-repay requirements. To rebut the presumption, the borrower must prove that the lender failed to consider their living expenses after accounting for their mortgage and other debts. As with the safe harbor protection, this does not protect lenders against lawsuits based on violations of other federal consumer protection laws.

Ability to Repay Rule

As a result of the widespread use of limited documentation or even no documentation to verify a borrower's income and assets, the CFPB has created the new Ability-to-Repay Rule, which requires sufficient documentation from the borrower and lender verification to determine that the borrower will be able to repay the loan.

Under the new rules, lenders must verify a borrower's financial documentation, and at a minimum, must look at 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%).

Borrowers must have sufficient income or assets to repay the mortgage loan, and it is up to lenders to verify that the borrower has enough income and/or assets to repay the loan. Other considerations include the prohibition on factoring introductory or "teaser" rates in to the determination of whether the borrower can repay the loan. Lenders must determine the borrower's ability to repay both the principal and the interest over the long term.

Ability-to-Repay Exemption

When a borrower attempts to refinance a risky loan, such as an adjustable-rate mortgage, an interest-only loan, or a negative amortization loan, to a more conventional loan, exemptions to the Ability-to-Repay rule apply. Lenders can finance the loan without undertaking the full underwriting process required by the new rules.

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, McCathern's Managing Partner and head of the Banking & Mortgage Section, at arnolds@mccathernlaw.com or 214.741.2662.