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Federal Reserve Issues Proposed Ability-to-Repay Rule

By Joseph Gabai

On April 19, 2011, the Federal Reserve Board ("Board") issued a proposed rule to implement ability-to-repay requirements for closed-end residential loans. The proposed rule is designed to implement 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"). This Client Alert provides background information, summarizes the proposed rule, and offers some commentary.

BACKGROUND

Dodd-Frank was enacted on July 21, 2010. Section 1411 of Dodd-Frank establishes a new ability-to-repay standard for certain closed-end residential mortgage loans. Section 1412 of Dodd-Frank establishes a presumption that a qualified mortgage ("QM") will meet the ability-to-repay standards of Section 1411. A provision in Section 1414 of Dodd-Frank prohibits prepayment penalties for residential mortgage loans that fail to meet the QM standard, and limits the prepayment penalties for residential mortgage loans that do meet the QM standard. A more detailed discussion of Sections 1411, 1412 and 1414 can be found in our Dodd-Frank Residential Mortgage User Guide at http://www.mofo.com/files/Uploads/Images/ResidentialMortgage.pdf.

A copy of the Board's 474 page proposal can be found at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20110419b1.pdf. The comment period for the proposal runs through July 22, 2011, one day after jurisdiction for writing these regulations shifts to the Consumer Financial Protection Bureau ("Bureau"). Therefore, while the Board authored the proposed regulation, the final rule will be written by the Bureau alone. The Bureau may have a different perspective and agenda than the Board, and the final rule may bear little resemblance to the proposal. To borrow from an old proverb, the Board proposes and the Bureau disposes.

SCOPE

The new rule applies to consumer credit transactions secured by a dwelling. Both principal and non-principal dwellings are included, and the included loans are referenced in the proposal as "covered transactions." Excluded from the new rule are home equity lines of credit and mortgages secured by interests in timeshare plans. Certain 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 exempt from the ability-to-repay requirement, the special rules for refinancing of non-standard mortgages, the QM rules, and the special rules for balloon-payment QMs made by certain creditors (but are not exempt from the limits on prepayment penalties).

IMPORTANCE OF THE ABILITY-TO-REPAY RULE AND QM TEST

The proposal relates to one of the pillars of Dodd-Frank's effort to address the perceived causes of the residential housing crises that began in 2007. Based on the belief that lenders frequently provided mortgage loans to unqualified borrowers, the proposal mandates that each covered transaction meet the new ability-to-repay requirement. Loans that qualify as

QMs will be given a compliance safe harbor for this requirement or, alternatively, a presumption of compliance, depending upon the approach chosen by the Bureau in the final regulation.

Meeting the terms of the new ability-to-repay requirement is critical, because borrowers in a foreclosure proceeding may assert a failure to comply as a defense by way of recoupment or set off, without regard to the normal statute of limitations under the federal Truth-in-Lending Act ("TILA"). See Section 1413 of Dodd-Frank. A violation of the ability-to-repay rule subjects the creditor to the usual TILA remedies, plus the same enhanced civil remedies that apply to violations of TILA's high-cost loan rules, and TILA authorizes the state attorneys general to bring actions for violations of the ability-to-repay rule for a three year period. See Section 1416 and Section 1422 of Dodd-Frank. As more fully discussed below, a loan that is a covered transaction must qualify as a QM (among other things) if the creditor wishes to include a prepayment penalty in the loan. In addition, one of the characteristics of a higher-risk mortgage loan (which is subject to enhanced appraisal requirements under Section 1471 of Dodd-Frank) is that the loan is not a QM. Also, a "qualified residential mortgage" under Section 941 of Dodd-Frank may not be broader in scope than a QM as defined in the final rule. Given the enhanced risk of civil liability, it remains to be seen whether, and to what extent, creditors will be willing to make residential mortgage loans that do not qualify as QMs, and whether the secondary market will be willing to buy non-QMs.

CURRENT RULE

There currently is an ability-to-repay test in the TILA regulations for high-cost mortgage loans and higher-priced mortgage loans. See Section 226.34(a)(4) and Section 226.35(b)(1) of Regulation Z. Given that the proposal would extend Dodd-Frank's enhanced ability-to-repay requirements to all covered transactions (except as noted above), the Board proposes to eliminate the existing ability-to-repay requirement for high-cost mortgage loans and higher-priced mortgage loans.

SUMMARY AND ANALYSIS

1. Ability-to-Repay Requirement (Section 226.43(c) of Regulation Z)

- *The Ability-to-Repay Test.* A creditor may not make a loan in a covered transaction unless it makes a reasonable and good faith determination, at or before consummation, that the consumer will have a reasonable ability to repay the loan, at the time of consummation, according to its terms, including any mortgage-related obligations.
    - ➢ *Comment.* On its face, the ability-to-repay test applies to new loans and refinancings. This means that the test should not apply to modifications of existing mortgages.
- *Snapshot Picture.* The ability-to-repay test is implemented by taking what amounts to a snapshot picture at the time of consummation – if the test is met at that point, the creditor will be deemed to be compliant, even if the borrower's circumstances undergo an adverse change thereafter.
    - ➢ *Basis for the Snapshot Picture.* Compliance will be determined based upon the borrower's application and other records. If the application or records indicate that a change in the borrower's circumstances are forthcoming, the creditor must take that information into consideration.

- *Comment.* It is evident that the application and other records will be scrutinized by plaintiff's counsel when a defaulting borrower later brings a lawsuit to challenge the creditor's adherence to the ability-to-repay requirement. This indicates the critical need for policies and procedures that govern every aspect of the application and underwriting process, and the need for a mechanism to police and assure adherence to those policies and procedures.

- *Factors to be Considered.* The Board's proposal identifies eight factors that the creditor must consider when determining the borrower's ability-to-repay: (i) the borrower's current or reasonably expected income or assets, (ii) the borrower's current employment status, (iii) the monthly payment for the covered transaction, (iv) the monthly payment for any simultaneous loans that the creditor knows or has reason to know of, (v) the borrower's monthly payment for mortgage-related obligations, (vi) the borrower's current debt obligations, (vii) the borrower's monthly debt-to-income ratio ("DTI") or residual income, and (viii) the borrower's credit history. Each of these is discussed in more detail below.

    - *Current or Reasonably Expected Income or Assets.* The creditor is permitted to rely on a wide range of income and assets, other than the value of the security property itself. The creditor is obligated only to consider the specific income streams and assets that it will rely upon to meet the ability-to-repay test. Expected income (*e.g.,* bonuses or income from a new job that will be commenced soon) can be relied upon only if it is reasonable to do so and is reasonably verified with third-party records. Seasonal or irregular income can be considered if reasonable to do so.

    - *Current Employment Status.* The creditor may consider full-time, part-time, seasonal, irregular, military, or self-employment. The creditor needs to consider and verify employment status only if it is relying on employment income. The employment of military personnel may be verified using the Department of Defense's database.

    - *Monthly Payment for the Covered Transaction.* In making the payment calculation, the creditor must use the greater of the fully-indexed rate (*i.e.,* the index or formula at consummation, plus the maximum margin under the loan documents during the term of the loan) or the introductory rate. In the case of an adjustable rate mortgage ("ARM"), instead of using the index value at consummation, the creditor may utilize any index value prior to consummation for up to the full look-back period for rate adjustments. In addition, for ARMs the creditor may apply the maximum rate cap contained in the loan documents. The creditor must calculate and use monthly, fully amortizing payments that are substantially equal, even if the loan terms do not call for such payments. The creditor must assume that the entire loan amount will be disbursed at consummation. Special rules apply when making the payment calculation for loans with balloon payment, interest-only, or negative amortization provisions, as follows:

        - *"Prime" Balloon Payment Loan.* If the loan has a balloon payment (*i.e.,* a payment that is more than two times any regular payment) and is not a higher-priced covered transaction, the ability-to-repay test is applied using the maximum payment scheduled for the first five years (including the balloon payment itself, if this is due during the first five years). If the borrower has a right to renew the balloon payment, the renewal term is not included in determining the term of the loan. A "higher-priced covered transaction" is a covered transaction where the annual percentage rate ("APR") exceeds the average prime offer rate ("APOR") for a comparable transaction, as of the date the interest rate is set by 1.5% or more for a first-lien transaction, or 3.5% or more for a junior lien transaction.

- *"Non-Prime" Balloon Payment Loan.* If the loan has a balloon payment and is a higher-priced covered transaction, the ability-to-repay test is applied using the maximum payment in the payment schedule, including the balloon payment itself. Given that very few borrowers can pay an entire balloon payment from their current and expected income and assets, it is likely that very few of these loans will be made.

- *Interest-Only Loan.* If the loan is an interest-only loan, the payment is calculated using the greater of the fully-indexed rate or any introductory rate, and amortizing the loan amount over the remaining term from the date the loan is recast in substantially equal monthly payments of principal and interest.

- *Negative Amortization Loan.* If the loan is a negative amortization loan, the payment is calculated using the greater of the fully-indexed rate or any introductory rate, and amortizing the maximum loan amount over the remaining term from the date the loan is recast in substantially equal monthly payments of principal and interest. The "maximum loan amount" is calculated based on the assumption that the borrower makes the minimum payments until the earlier of the negative amortization cap or until the period permitting minimum payments expires; also, it is assumed that the interest rate will increase as quickly as possible to the maximum interest rate cap. This very conservative methodology is consistent with Dodd-Frank's overall approach with respect to negative amortization loans – these loans are not prohibited, but the new disclosure and other requirements are designed to make it as difficult and unpleasant as possible to offer these loans.

- *Monthly Payment for any Simultaneous Loans.* A "simultaneous loan" includes any covered transaction or home equity line of credit made to at least one of the same borrowers at or before the consummation of the covered transaction in question. The simultaneous loan may be made by the same creditor that is making the covered transaction in question, or by a different creditor. An example would be a piggyback loan that the creditor knows or has reason to know about. In most instances, the creditor will have to verify the simultaneous loan provided by a third-party lender by obtaining third-party verification from that lender (*e.g.,* a copy of the promissory note or other written verification), given that this information will not yet be reflected in a credit report on the borrower.

  - *Calculation of Payment on Simultaneous Loan.* If the simultaneous loan itself is a covered transaction, then the monthly payment is calculated as set forth above. If the simultaneous loan is a home equity line of credit, the payment is calculated by using the periodic payment that would be required for the amount of credit to be drawn down (*i.e.,* requested by the borrower) at the time of the consummation of the covered transaction in question, although when this amount will actually be disbursed or the actual receipt of funds is not determinative.

- *Monthly Payment for Mortgage-Related Obligations.* This includes payments for mortgage-related obligations for both the covered transaction in question, as well as any simultaneous loans. Mortgage-related obligations include property taxes, homeowner's association and similar fees, ground rents, special assessments, mortgage insurance, property insurance (with some narrow exceptions), and other creditor-required insurance coverage. Certain coverages not required by the creditor, such as optional earthquake insurance and optional debt cancellation coverage, need to be included. Mortgage-related obligations imposed other than monthly need to be converted to a monthly amount for purposes of this calculation. Mortgage-related obligations should be based on the information known or reasonably available at the time of loan underwriting, and verified from reasonably reliable records. Estimates may be used if actual amounts are unknown at the time of underwriting. Estimates of future increases in taxes and insurance need not be projected.

- *Current Debt Obligations.* Current debt obligations can be determined through the use of widely accepted government and non-government underwriting standards. As an example of that standard, the Board's Commentary refers to the Federal Housing Administration's Handbook on Mortgage Credit Analysis for Mortgage Insurance on One-to-Four Unit Mortgage Loans. Obligations include payment obligations of all kinds, such as consumer loans, alimony, child support, and other mortgages. These obligations must be verified through third-party records. If the borrower's credit report reflects such an obligation, it must be considered in the ability-to-repay determination, even if the obligation is not identified in the borrower's application. If the obligation is identified in the borrower's application, but not in the credit report, it must still be considered in the ability-to-repay determination, but need not be verified through a third-party source. However, if the creditor nonetheless verifies the obligation, the creditor then must use the information provided by the third-party source.

- *Monthly Debt-To-Income Ratio or Residual Income.* For this purpose, the DTI is calculated by dividing (a) the sum of the payment on the covered transaction in question, the payment on any simultaneous loans, the monthly payment for mortgage-related obligations, and the current debt obligations (all calculated as set forth above) by (b) the sum of the borrower's current or reasonably expected income, plus income from assets (all calculated as set forth above). The monthly residual income is calculated by subtracting item (a) above from item (b) above.

    - *Thresholds.* The proposed rule does not identify a specific maximum DTI or minimum residual income, but simply states that the creditor may look to widely accepted government and non-government underwriting standards. It would have been helpful if the Board had identified a specific maximum DTI or minimum residual income for different loan types or situations because this would have eliminated any uncertainty regarding the acceptable level.

    - *Use of Both DTI and Residual Income.* The creditor is permitted to use both a monthly DTI and monthly residual income test, but then can choose which of these to consider in applying the ability-to-repay standard.

    - *Compensating Factors.* The creditor is permitted to consider compensating factors to mitigate a higher DTI or lower residual income. Once again, creditors may use widely accepted government and non-government underwriting standards, but no specific guidance is provided, leaving creditors and investors at risk if they should apply compensating factors.

- ✓ *Comment.* Compensating factors must not be applied in a manner that treats borrowers differently based on race, national origin, or other prohibited bases.

- ➢ *Automated Underwriting Systems.* The Board has solicited comment on providing a safe harbor for relying on an Automated Underwriting System ("AUS") that uses monthly DTIs, if the AUS developer certifies that the AUS's use of monthly DTIs in determining repayment ability is empirically derived and statistically sound. Such a safe harbor would be extremely valuable to mortgage lenders and investors alike.

- ➢ *Credit History.* In defining and verifying credit history, the creditor may look to widely accepted government and non-government underwriting standards. In practice, creditors can be expected to verify credit history through the use of credit reports and third-party records such as rental payment histories.

- *Verification of Repayment Ability.* The creditor must verify the borrower's ability to repay through the use of reasonably reliable third-party records for all items relating to the ability-to-repay. The records must be specific to the borrower, but may be obtained from a third party (*e.g.,* an employer verifying income) or the borrower him/herself (*e.g.,* payroll statements). Employment status may be verified orally by the employer, so long as this is memorialized.

- *Verification of Income and Assets.* The amount of the borrower's income and assets must be verified through the use of reasonably reliable third-party records. This includes IRS tax return transcripts obtained from the borrower or a service provider, W-2s, payroll statements, financial institution records, proof of income letters from the Social Security Administration, and various other third-party sources. The creditor only needs to verify the income or assets that the creditor actually relies on to determine the ability-to-repay.

- *Comment.* As can be seen, the basic ability-to-repay test is very fact-intensive. This creates uncertainty in the application of the test, which creditors and investors detest. This uncertainty, in turn, establishes an incentive for creditors to offer QMs.

2. Refinancing of a Non-Standard Mortgage into a Standard Mortgage (Section 226.43(d) of Regulation Z)

- *Concept.* When a non-standard mortgage is refinanced into a standard mortgage and certain conditions are met, the creditor is relieved from compliance with the ability-to-repay rule's duty to verify the borrower's income or assets. In addition, these refinancings allow the creditor to utilize a different payment calculation than is used under the ability-to-repay rule. This is designed to facilitate streamlined refinances of current but vulnerable loans into much less risky loans.

  - ➢ *Comment.* There is much to dislike about this proposal. It is too limited in its scope, as it does not facilitate streamlined refinances for many other borrowers who could benefit from them, to the detriment of borrowers, investors and servicers alike.

- *Conditions.* The exemption is available when a non-standard mortgage is refinanced into a standard mortgage and the following conditions are met: (i) the creditor for the standard mortgage is the current holder or servicer of the non-standard mortgage; (ii) the monthly payment on the standard mortgage is materially lower than the monthly payment on the non-standard mortgage; (iii) the creditor receives the borrower's written application for the standard mortgage before the non-standard mortgage is recast; (iv) 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; (v) 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; (vi) 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 (vii) the creditor has considered whether the standard mortgage will prevent the borrower's default.

- *"Refinancing."* A "refinancing" is defined by reference to the definition in existing Section 226.20(a) of Regulation Z. In general, a refinancing is a transaction in which an existing obligation is satisfied and replaced by a new obligation undertaken by the same consumer. However, Section 226.20(a) goes on to identify certain transactions that are not regarded as refinancings even if the new obligations do satisfy and replace the existing obligations.

- *Non-Standard Mortgage.* For this purpose, 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 (*e.g.,* a 2/28 ARM), an interest-only loan, or a negative amortization loan. Note that many balloon payment loans do not qualify as "non-standard mortgages" (*e.g.,* a loan with principal and interest payments based on a 30-year amortization, with a balloon payment due after 10 years).

- *Standard Mortgage.* For this purpose, a standard mortgage is a covered transaction that provides for regular periodic payments that do not cause the principal balance to increase, do not allow the borrower to defer repayment of principal, and do not result in a balloon payment; the total points and fees do not exceed the permitted percentage of the total loan amount (discussed below, in the context of QMs); 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 RESPA-disclosable closing costs (including escrow amounts).

- *Materially Lower Payment.* The monthly payment on the standard mortgage must be materially lower than the monthly payment on the non-standard mortgage. Whether the monthly payment is materially lower will depend on all the facts and circumstances, an unhelpful standard. The Board's Commentary provides what is in effect a safe harbor, stating that a 10% or larger reduction in the monthly payment will meet the "materially lower" standard. In practice, creditors are likely to use the 10% or more threshold in all cases.

- *30-Days Late.* In determining whether a payment was 30 days or more late, it is necessary to look to the date that the payment was actually due. That is, any grace period should be ignored.

- *Likelihood of Default.* In determining whether the borrower is likely to default on the non-standard mortgage (mistakenly referred to in the proposal as the standard mortgage) once it is recast, the creditor may look to widely-accepted governmental and non-governmental standards.

- *When the Non-Standard Mortgage has been "Recast."* 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.

- *Monthly Payment Calculation.* In determining whether the "materially lower payment" test has been met, it is necessary to compare the monthly payment for the non-standard mortgage with the monthly payment for the standard mortgage. The Board's proposal sets forth rules for determining the monthly payments for both loans.

  - *Monthly Payment for Non-Standard Mortgage.* Regardless of the actual terms of the non-standard mortgage following the upcoming recast, the monthly payment for this purpose is deemed to be a substantially equal, monthly, fully amortizing payment of principal and interest. This payment is calculated based on the fully indexed rate as of a reasonable time (generally, 30 days) before or after the date the creditor receives the borrower's written application for the standard mortgage, the remaining scheduled term of the loan following the recast, and the remaining loan amount. For an ARM or an interest-only loan, the remaining loan amount is the anticipated principal balance as of the recast date (assuming the payment due on the recast date is paid). For a negative amortization loan, the remaining loan amount is the maximum loan amount (discussed above).

  - *Monthly Payment for Standard Mortgage.* The monthly payment for this purpose is deemed to be a substantially equal, monthly, fully amortizing payment of principal and interest. This payment is calculated based on the maximum interest rate for the first five years of the loan following consummation. For an ARM, note that the initial rate must remain in effect for the full five-year period. For a step-rate mortgage without a variable rate feature, the highest rate in effect during the five-year period must be used to calculate the monthly payment.

  - *Comment.* The monthly payment calculation for a standard mortgage will usually result in a lower payment than the monthly payment calculation required by the general ability-to-repay test. As a result, assuming that the other necessary conditions are met, more loans are likely to qualify for a refinancing under Section 226.43(d) than under the general ability-to-repay test.

- *Offer of More Favorable Rate or Terms.* The creditor may offer the borrower the same or a more favorable rate or terms than it offers new customers. However, the creditor must comply with other applicable laws (*e.g.,* fair lending laws) when doing so. The creditor must have documented underwriting practices to support the creditor's offer of rate discounts and loan terms.

3. Qualified Mortgages (Section 226.43(e) of Regulation Z)

- *Safe Harbor vs. Presumption of Compliance.* The Board's proposal outlines two alternative, and fundamentally different, approaches for the QM concept. With the safe harbor alternative, the Board states that a QM will be deemed to comply with the ability-to-repay test. Under this approach, 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 creditor or assignee will need to demonstrate that the loan meets the ability-to-repay test. In contrast, with the presumption of compliance alternative, the Board states that a QM is presumed to have complied with the ability-to-repay test. Even if the mortgage is a QM, however, the borrower can rebut the presumption of compliance with evidence that the mortgage did not meet the basic ability-to-repay test. The Board has requested comment on whether the safe harbor approach or presumption of compliance approach should be utilized. Whichever approach is selected in the final regulation, both creditors and assignees will be permitted to take advantage of the QM status of a loan.

  - *Comment.* Mortgage lenders, investors, and servicers will favor the safe harbor approach because of the protection from liability that it will afford. Consumer groups and the plaintiff's bar will favor the presumption of compliance approach, because it will provide them with the opportunity to challenge the ability-to-repay for any mortgage, particularly those that go to foreclosure. If the safe harbor approach is selected, creditors will have a particularly strong incentive to make QMs.

- *Definition of a Qualified Mortgage.* A QM is a mortgage that lacks what are perceived to be risky features. The term is defined to mean a covered transaction that (i) provides for regular periodic payments (except for payment changes that result from rate changes in an ARM or step-rate loan) that do not result in an increase in principal, allow the borrower to defer repayment of principal (*e.g.,* an interest-only loan or partially amortizing loan), or result in a balloon payment (except for the special balloon-payment QMs discussed below). Note that a single-payment loan cannot be a QM; (ii) has a loan term of no more than 30 years; (iii) has total points and fees that do not exceed the permitted percentage of the total loan amount (discussed below); (iv) the creditor underwrites by including all mortgage-related obligations (discussed above; however, the Board's Supplementary Information states that mortgage-related obligations need not be verified); and (v) the creditor underwrites using the maximum interest rate that will apply at any time during the first five years following consummation (assuming that the interest rate for an ARM will rise as quickly as possible, taking any contractual rate caps into consideration) and periodic payments of principal and interest that will repay either (a) the outstanding principal over the remaining loan term once that maximum interest rate is reached, or (b) the loan amount as of the date of consummation over the loan term. Under one alternative posed by the Board, the creditor also must consider and verify the borrower's current or reasonably expected income or assets to determine the borrower's repayment ability. Under the second alternative posed by the Board, the creditor also must consider and verify the borrower's current or reasonably expected income or assets (other than the value of the dwelling in question), the borrower's current employment status (if 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.

  - *Comment.* The second alternative posed by the Board more or less subjects the creditor to the same burdens that would be encountered under the basic ability-to-repay test.

- *Points and Fees Test.* For a loan to be a QM, the total points and fees may not exceed the designated percentage of the total loan amount. Once again, the Board has presented two alternative approaches for comment.

  - *Points and Fees Cap Based on Loan Amount Tier.* The first approach establishes different caps on points and fees based upon the loan amount tier. Under this approach, the maximum points and fees are 3% of the total loan amount for loans of $75,000 or more, 3.5% of the total loan amount for loans of $60,000 or more but less than $75,000, 4% of the total loan amount for loans of $40,000 or more but less than $60,000, 4.5% of the total loan amount for loans of $20,000 or more but less than $40,000, and 5% of the total loan amount for loans of less than $20,000.

- *Comment.* In some instances, the first approach will allow a greater dollar amount of points and fees for a smaller loan.

- *Points and Fees Cap Based on Loan Amount Tier or Formula.* The second approach also establishes maximum points and fees of 3% of the total loan amount for loans of $75,000 or more, and maximum points and fees of 5% of the total loan amount for loans of less than $20,000. For loans of $20,000 or more but less than $75,000, a formula is used, as follows: (i) total loan amount – $20,000 = $Z; (ii) $Z x .0036 = Y; (iii) 500 – Y = X; and (iv) X x .01 = the maximum points and fees as a percentage of the total loan amount.

- *Comment.* Both alternative proposals are likely to disappoint mortgage lenders and investors because the proposals provide little flexibility. The industry was certainly hoping for a much higher dollar threshold than $75,000 for the triggering of a larger percentage points and fees test. If either proposal is adopted in final form, a much larger percentage of loans than expected will fail to qualify as QMs.

- *Comment.* The Board's Supplementary Information states that both proposals seek to ensure that a loan that is a QM will not also be a high-cost mortgage based solely on the points and fees. Whether this will, in fact, be true will depend on the regulations that implement Dodd-Frank's new high-cost mortgage provisions.

- *Definition of "Points and Fees."* The term "points and fees" is defined by reference to the definition of that term in the revised high-cost mortgage rules, which include the following: (i) all finance charges under Section 226.4(a) and (b) of Regulation Z (except interest; time-price differential; mortgage insurance premiums assessed under a federal or state agency program; mortgage insurance premiums not in excess of the amount payable under policies in effect at origination under §203(c)(2)(A) of the National Housing Act (regardless of when or how paid), provided that the premiums are automatically refundable on a pro rata basis upon notification of the satisfaction of the mortgage; or mortgage insurance premiums payable after loan closing); (ii) all compensation payable directly or indirectly to loan originators (*e.g.,* third-party mortgage brokers, table-funding creditors, and in-house loan officers); (iii) 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; (iv) premiums payable at or before loan closing for certain credit insurance or debt cancellation/suspension coverage, whether mandatory or optional; (v) the maximum prepayment penalty that may be collected for the loan; and (vi) 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. 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.

- *Compensation to Loan Originators.* A "loan originator" is defined by reference to the definition in the Board's loan originator compensation rule. See Section 226.36(a) of Regulation Z. Compensation to loan originators is included in the points and fees. This compensation is broadly defined to include commissions, bonuses, trips, prizes, and hourly pay for the actual number of hours worked on a particular loan. Both the name of the fee and the identity of the payor of the fee are irrelevant. It also is irrelevant whether the compensation is paid before, at or after the loan closes. The Board's Commentary provides examples of how bonus policies of various types can be used to determine the compensation attributable to any particular loan. 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 last of these provisions favors creditors (which are able to exclude the base salaries of their loan originator employees) and disfavors third-party mortgage brokers (for which the proposed rule does not provide a similar exclusion). This is consistent with the favoring of creditors over mortgage brokers by the Board's loan originator compensation rules that recently became effective.

- *Exclusion of Bona Fide Third-Party Charges.* For purposes of the QM points and fees test, bona fide third-party charges (other than includable mortgage insurance premiums) may be excluded so long as they are not paid to the creditor, a loan originator, or an affiliate of either. The Board 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.

- *Exclusion of Bona Fide Discount Points.* For purposes of the QM points and fees test, up to two bona fide discount points can be excluded if the interest rate before discount does not exceed by more than 1% the APOR for a comparable transaction as of the date the interest rate is set for the discounted interest rate. If these discount points have not been excluded, then up to one bona fide discount point can be excluded if the interest rate before discount does not exceed by more than 2% the APOR for a comparable transaction as of the date the interest rate is set for the discounted interest rate. To be a bona fide discount point, the calculation must both (i) be consistent with established industry practice, and (ii) account for the amount of compensation that the creditor can reasonably expect to receive from secondary market investors for the loan. In other words, the creditor must be in a position to justify its pricing for the discount points based on mortgage lending industry practice and, in addition, that pricing must be corroborated by the pricing of the loan in the secondary market. Creditors would be well advised to document their determinations of bona fide discount points for purposes of the QM points and fees test.

- ✓ *Comment.* Section 1431 of Dodd-Frank allows a deduction of certain bona fide discount points from the calculation of "points and fees" for purposes of the high-cost mortgage definition. Those provisions are not being implemented in the Board's proposed ability-to-repay regulation.

- ➢ *Definition of "Total Loan Amount."* The term "total loan amount" is defined by reference to the definition of that term in the revised high-cost mortgage rules. The "total loan amount" is calculated by deducting the following items from the Amount Financed (as that term is defined in Regulation Z): (i) 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; (ii) premiums payable at or before loan closing for credit insurance or debt cancellation/suspension coverage, whether mandatory or optional; and (iii) 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, so long as items (i), (ii) and (iii) are included in the points and fees (as they should be) and are financed by the creditor. The Board has solicited comment on an alternative calculation of the "total loan amount" – one that would be 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. This alternative would be a simpler calculation and would generally result in a larger "total loan amount" (thereby facilitating the charging of more points and fees on the loan).

- ➢ *Definition of "Prepayment Penalty."* For purposes of determining both the numerator and denominator of the points and fees calculation for the QM test, it is necessary to identify prepayment penalties. For this purpose, 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. The term is broadly defined to include (i) traditional prepayment charges, (ii) any interest that is charged on a loan balance after the date that any part of it is prepaid (*e.g.,* 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 (iii) a closing cost or other fee that is waived unless the borrower prepays the loan. The inclusion of item (ii) will undoubtedly disappoint creditors that offer government loans. 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, reconveyance documents or documents to release the creditor's security interest.

- ➢ *Comment.* In contrast with existing law, the proposed rule increases some amounts going into the numerator and decreases some amounts going into the denominator of the points and fees percentage calculation. As a result, for many creditors the calculation will result in a higher percentage than at present. This will make it even more difficult for these creditors to meet the points and fees test and qualify their loans as QMs. Over time, this may result in growing disuse of prepayment penalties, which are a significant element in the new points and fees calculation.

- *Comment.* As proposed, the exact same ability-to-repay test applies for both lower- and higher-income borrowers alike. Sophisticated and well-heeled borrowers are far more able to determine their own capacities to manage their mortgage and other obligations, and the "one-size-fits-all" approach of the proposed definition of a QM frustrates the ability of creditors to offer tailored mortgage solutions that best meet the unique needs of their wealthier borrowers. There is sufficient flexibility in Dodd-Frank's definition of a QM to enable the Bureau to establish a separate QM definition for these borrowers. Also see 15 U.S.C. §1604(g), which authorizes the Board (or, soon, the Bureau) to establish exemptions from any of the provisions of TILA for borrowers with annual earned incomes over $200,000 or net assets in excess of $1,000,000, so long as they execute handwritten waivers. To date, the Board has not exercised this authority.

4. Balloon-Payment Qualified Mortgages (Section 226.43(f) of Regulation Z)

- *Definition of a "Balloon-Payment Qualified Mortgage."* The Board proposes to establish a special form of QM known as a "balloon-payment qualified mortgage" ("BPQM"). BPQMs are meant to accommodate certain community banks that wish to hedge against interest rate risk. A BPQM is a loan that generally qualifies as a QM but includes a balloon payment. Also, a BPQM is not subject to the requirement that the loan be underwritten based on a fully amortizing payment schedule that takes into account all mortgage-related obligations and uses the maximum interest rate that may apply during the first five years after consummation. However, a BPQM must satisfy the following requirements: (i) the creditor must determine that the borrower can make all of the scheduled payments, other than the balloon payment, from the borrower's current or reasonably expected income or assets (not including the dwelling that secures the loan); (ii) the scheduled payments are calculated using an amortization period (regardless of the actual loan term) that does not exceed 30 years and includes all mortgage-related obligations; (iii) the loan term is five years or longer; (iv) during the preceding calendar year, the creditor extended more than 50% of its total covered transactions that provide for balloon payments in one or more counties designated by the Board as "rural" or "underserved"; (v) during the preceding calendar year, the creditor and its affiliates (a) extended covered transactions with loan amounts that aggregated $____ or less (Alternative 1) or (b) extended ___ or fewer covered transactions (Alternative 2) (the proposal solicits comment on an appropriate dollar amount or number of transactions); (vi) (a) on or after the effective date of the final rule, the creditor has not transferred legal title to any covered transaction that includes a balloon payment (Alternative 1) or (b) during the preceding and current calendar year, the creditor has not transferred legal title to any covered transaction that includes a balloon payment (Alternative 2); and (vii) as of the end of the preceding calendar year, the creditor had total assets that did not exceed an asset threshold ($2 billion for 2011), which asset threshold is to be revised annually by the Board based on movements in the Consumer Price Index. In addition, BPQMs are subject to certain requirements to which all QMs are subject: 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 (discussed above), and the loan must satisfy the consideration and verification requirements discussed above.

    - *Comment.* The Board's Supplementary Information suggests that the Board was considering using $100 million for the Alternative 1 blank in item (v)(a) above and 100 loans per year for the Alternative 2 blank in item (v)(b) above. Regardless of how the Bureau fills in the appropriate blank in item (v) above, and regardless of the other alternatives selected by the Bureau in the final regulation, it is likely that few mortgage lenders of any significant size will qualify to offer BPQMs. It is also unlikely that BPQMs will have a meaningful impact on the overall profile of the nation's residential mortgage market.

- *Definition of "Rural."* For purposes of the BPQM rule, a county is "rural" if it is not in a metropolitan statistical area or a micropolitan statistical area, and (a) is not adjacent to any metropolitan statistical area or a micropolitan statistical area, or (b) is adjacent to a metropolitan statistical area with fewer than one million residents or adjacent to a micropolitan statistical area, and it contains no town with 2,500 or more residents. The terms "metropolitan statistical area" and "micropolitan statistical area" are defined by reference to the definitions used by the U.S. Office of Management and Budget.
- *Definition of "Underserved."* For purposes of the BPQM rule, a county is "underserved" during a calendar year if no more than two creditors extended covered transactions five or more times in the county.
- *Determination of "Rural" and "Underserved" Status.* The Board publishes on its web site an annual list of "rural" and "underserved" counties.

5. Limits on Prepayment Penalties (Section 226.43(g) of Regulation Z)

- *When Prepayment Penalties are Permitted.* A covered transaction may not include a prepayment penalty unless all of the following conditions are met: (i) the prepayment penalty must be otherwise permitted by applicable law, (ii) the APR of the loan cannot increase after consummation (note that the APR of a fixed-rate mortgage or a step-rate mortgage without a variable rate feature does not increase after consummation), (iii) the loan must be a QM or a BPQM, and (iv) the loan must not be a higher-priced mortgage loan under separately proposed Section 226.45 of Regulation Z (*i.e.,* 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).
    - ➢ *Comment.* The Board also proposes to delete the existing limitations in Section 226.35(b)(2) of Regulation Z, relating to prepayment penalties for higher-priced mortgage loans. The Board is not proposing at this time to delete the existing limitations in Section 226.32(d)(7) of Regulation Z, relating to prepayment penalties for high-cost mortgage loans. The Board (or, more likely, the Bureau) will deal with the high-cost mortgage issue at a later time.
    - ➢ *Comment.* Note that 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. Since a closed-end reverse mortgage involves the addition of interest and fees to the principal balance, a reverse mortgage will not qualify as a QM and, therefore, cannot include prepayment penalties.
- *Duration of Prepayment Penalty Period.* A prepayment penalty may not be imposed more than three years after the consummation of the loan.
- *Amount of the Prepayment Penalty.* A prepayment penalty may not exceed 3% of the outstanding loan balance prepaid if incurred during the first year after consummation of the loan, may not exceed 2% of the outstanding loan balance prepaid if incurred during the second year after consummation of the loan, and may not exceed 1% of the

outstanding loan balance prepaid if incurred during the third year after consummation of the loan.

- *Comment.* For purposes of the points and fees test, a loan that includes the maximum prepayment penalties described above must include 3% of the entire outstanding loan balance as part of the points and fees. As noted in the Board's Supplementary Information, this means that the creditor and loan originators would have to forego any other points and fees in order to meet the QM test.

- *Comment.* This prepayment penalty formula (which applies the applicable percentage against the outstanding loan balance *prepaid*) is less generous to the mortgage holder than the formula in Dodd-Frank (which applies the applicable percentage against the *entire* outstanding loan balance).

- *Mandatory Offer of Loan With No Prepayment Penalty.* If the creditor offers a covered transaction that contains a prepayment penalty, the creditor must also offer a covered transaction that does not contain a prepayment penalty ("alternative loan"). The alternative loan must meet all of the following conditions: (i) the APR of the alternative loan must not increase after consummation; (ii) the alternative loan must be the same type of loan (*i.e.,* as applicable, fixed-rate or step-rate) as the loan with the prepayment penalty; (iii) the alternative loan must have the same term as the loan with the prepayment penalty; (iv) the alternative loan must provide for regular periodic payments that do not result in an increase in the principal balance, do not allow the borrower to defer the repayment of principal and do not result in a balloon payment (unless the loan is a BPQM); (v) the alternative loan must have total points and fees that do not exceed the permitted percentage of the total loan amount for a QM (discussed above), based on information known to the creditor at the time the alternative loan is offered; and (vi) the creditor must have a good faith belief that the borrower likely qualifies for the alternative loan, based on information known to the creditor at the time the alternative loan is offered. For purposes of item (vi), the creditor may rely on information provided by the borrower, even if it is subsequently determined to be inaccurate.

  - *Comment.* Item (vi) above is designed to prevent the creditor from circumventing the duty to offer an alternative loan. If the creditor determines that the borrower cannot qualify for any alternative loan, then the creditor should not offer a loan with a prepayment penalty.

  - *Comment.* Nothing in the proposed regulation prohibits the creditor from offering an alternative loan with a higher interest rate than the loan with the prepayment penalty. In fact, the Board's Supplementary Information confirms that the creditor may offer an alternative loan that is a higher-priced mortgage loan. Note, however, that item (vi) above precludes the creditor from offering a higher-rate loan as an alternative loan unless the creditor has a good faith belief that the borrower will qualify for the alternative loan.

  - *Comment.* The Board's Supplementary Information notes that the alternative loan need not be offered at or by a particular time. However, the Board is soliciting comments on this issue.

  - *Comment.* For purposes of this rule, a "prepayment penalty" is defined as set forth above. This could be problematic for creditors that offer government loans which 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 creditor charges such 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 creditor will be required also to offer an alternative loan.

- *Brokered Transactions.* If the loan with a prepayment penalty is offered through a mortgage broker, the creditor must also present the mortgage broker with an alternative loan that meets the conditions described above. The creditor may meet this requirement by presenting a rate sheet to the mortgage broker that includes the terms of the alternative loan. The creditor must have an agreement with the mortgage broker that requires the mortgage broker to present an alternative loan to the borrower. This can be part of the general compensation agreement between the creditor and mortgage broker, or it can be in the form of a separate agreement. 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).

  - *Comment.* Note that the mortgage broker must still comply with the anti-steering provisions in the Board's loan originator compensation rule. If the mortgage broker wishes to utilize the safe harbor provided in that regulation, it will still need to present the borrower with the loan options required by that safe harbor.

- *Creditor that is a Loan Originator.* If the creditor is also a loan originator (*e.g.,* a table-funded transaction), the creditor must present an alternative loan that meets the conditions described above that is offered by the assignee or by another person (if the loan offered by the other person has a lower interest rate or lower total dollar amount of origination fees and discount points).

  - Comment. As in the mortgage broker context, the creditor/loan originator must still comply with the anti-steering provisions in the Board's loan originator compensation rule. If the creditor/loan originator wishes to utilize the safe harbor provided in that regulation, it will still need to present the borrower with the loan options required by that safe harbor.

- *When There is No Violation.* There is no violation of the rule relating to alternative loans if the covered transaction is closed without a prepayment penalty or no covered transaction is closed at all.

- *Records.* If a covered transaction contains a prepayment penalty, the creditor must maintain records that document compliance with the rules for offering an alternative loan.

6. Miscellaneous

- *Record Retention.* The record retention requirement for compliance with the ability-to-repay rule is three years after consummation of the loan. For example, 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. Actual paper copies need not be retained so long as the creditor can reproduce the records accurately. The record retention requirement for other provisions of Regulation Z (other than with respect to the advertising rules) remains at two years after the date that disclosures are required to be made. The administrative agencies retain the right to require creditors to retain records for a longer period if necessary to carry out their enforcement responsibilities. See Section

226.25 of Regulation Z.

- *Evasion.* A creditor may not structure what is truly a covered transaction as an open-end loan in order to evade the requirements of the ability-to-repay rule. Any such loan must comply with Regulation Z's closed-end credit rules, including the ability-to-repay rule.

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