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Practice Area: Banking and Commercial Finance

All bankers should be aware of the fast-approaching implementation date (January 10, 2014) for recent CFPB mortgage-lending regulations under Dodd-Frank. For compliance officers, it is especially important to be familiar with the most recent series of amendments – particularly the ability to repay rules (the "ATR Rules") – to ensure that the most up-to-date consumer lending compliance policies and procedures are in place.

Since the establishment of the Consumer Financial Protection Bureau under the Dodd-Frank Act, the CFPB has been very busy issuing final rules to implement various provisions of the Act. These rules are intended to protect consumers from unfair, deceptive or abusive acts or practices. The CFPB's new rules: (1) create an ability to repay standard (the ATR Rules), (2) expand consumer protections under the Home Ownership and Equity Protection Act (HOEPA), (3) affect who is considered to be a loan originator and how a loan originator is compensated, (4) create new procedures and standards for appraisals, (5) broaden the requirements for the establishment of escrow accounts, and (6) impact how certain residential mortgage loans are serviced.

The ATR Rules will have a profound impact on the origination of residential mortgage loans, and generally require creditors to make a reasonable, good faith determination of a consumer's ability to repay a residential mortgage loan. With the effective date of the ATR Rules fast approaching (January 10, 2014), it is crucial that financial institutions understand their compliance obligations. This *Commercial Law Update* summarizes the key aspects of the CFPB's amendments to the ATR Rules published on June 12, July 24 (as corrected on July 30) and October 1 of this year.

Loan Originator Compensation and the Points and Fees Calculation
Points and fees is an important aspect of the ATR Rules because a loan generally cannot be considered a "Qualified Mortgage" ("QM") (for which compliance with the ATR Rules is presumed) if points and fees exceed 3% of the total loan amount.

The June 12 amendment provided that the amount a consumer pays directly to a mortgage broker (whether an individual or an entity) should be included in the points and fees calculation; however, if this payment is already included in points and fees because it is included in the finance charge, it does not have to be included again as loan originator compensation. In addition, compensation paid by a mortgage broker to its employee that is already included in points and fees as loan originator compensation paid by the consumer or the creditor should be excluded from points and fees. While compensation paid by a creditor to its own lending officers should be excluded from points and fees, compensation paid by a creditor to a mortgage broker should continue to be included, in addition to up-front charges paid by the consumer to the creditor.

The October 1 amendment further clarified when charges paid by third parties (including seller's points) must be included in points and fees. Creditors may now rely on written statements from the borrower or a third party (including the seller) as to the source of the funds and the purpose of the payment when determining what items must be included in points and fees.

The October 1 amendment also provided that compensation paid by a manufactured home retailer to its employees must be excluded from the points and fees calculation. To the extent that an employee of a manufactured home retailer receives from another source (such as the creditor) loan originator compensation that can be attributed to the transaction at the time the interest rate is set, then that compensation must be included in points and fees. Moreover, if a creditor has knowledge that the sales price of a manufactured home includes loan originator compensation, then that compensation must be included in points and fees. This requirement does not, however, impose an affirmative obligation on the creditor to investigate the retailer's sales prices to determine if it includes such compensation.

The October 1 amendment also clarified that points and fees include any prepayment charges triggered by the refinancing of an existing closed-end credit transaction or the termination of an open-end credit transaction (*e.g.*, a HELOC) by obtaining a new credit transaction with the current holder of the existing closed-end mortgage loan or open-end credit plan.

Small Creditor Portfolio and Balloon-Payment QMs
Under Regulation Z, a "small creditor" is defined as a creditor that (along with its affiliates) originated 500 or fewer first-lien mortgages covered under the ATR Rules during the preceding calendar year and has no more than $2 billion in assets as of the end of the preceding calendar year.

The June 12 amendment established a new, fourth category of a QM for certain loans originated and held in portfolio for at least three years (subject to certain limited exceptions) by small creditors, regardless of whether such creditors operate predominantly in "rural" or "underserved" areas. The loans must meet the general restrictions on QMs with regard to loan features and points and fees, and creditors must evaluate a consumer's DTI ratio or residual income; however, the loans are not subject to a specific DTI ratio as they would be under the general QM definition (*i.e.*, 43%).

The June 12 amendment provided for a two-year transition period (until January 10, 2016) during which all small creditors can offer balloon-payment QMs if they hold the loans in portfolio. Balloon-payment QMs that are originated during this two-year period will retain their QM status after January 10, 2016, assuming the requirements to hold the loan in portfolio are met. After that date, the balloon-payment QM category only extends to small creditors that operate predominantly in rural or underserved areas. For determining eligibility for the small creditor or balloon-payment QM "safe harbor" (*i.e.*, QMs that are not higher-priced covered transactions), the June 12 amendment increased the threshold from 1.5 percentage points above the average prime offer rate on first-lien loans to 3.5 percentage points above the average prime offer rate.

Clarification of GSE or Federal Agency Purchase, Guarantee, or Insurance Eligibility for QM Status
For the QM determination for loans that are eligible for purchase, guarantee, or insurance by GSEs or federal agencies, the July 24/30 amendment clarified that matters wholly unrelated to ability-to-repay will not be relevant to the determination of QM status (*e.g.*, those matters wholly unrelated to credit risk or the underwriting of the loan). Further, loans that meet the eligibility requirements provided in a written agreement with, or otherwise receiving individual waivers from, one of the GSEs or federal agencies are eligible for QM status. The July 24/30 amendment also clarified that a repurchase or an indemnification demand by a GSE or federal agency is not dispositive for determining whether or not the loan was a QM. In addition, a creditor that is relying on approval through an automated underwriting system to establish QM status must also meet the conditions on approval that are generated by that same system.

Exemptions for Certain Creditors and Lending Programs
Per the June 12 amendment, the ATR Rules now exempt, under certain circumstances, creditors designated by either the U.S. Department of the Treasury as "Community Development Financial Institutions" and creditors designated by HUD as either a "Community Housing Development Organization" or a "Downpayment Assistance Provider of Secondary Financing."

In addition, 501(c)(3) entities are exempt provided that they: (1) extend credit no more than 200 times during the calendar year preceding receipt of the consumer's application, (2) provide credit only to low-to-moderate income consumers, and (3) follow their own written ability-to-repay procedures for their consumers.

The June 12 amendment also exempted extensions of credit made pursuant to programs administered by a housing finance agency or an Emergency Economic Stabilization Act program (*e.g.*, extensions of credit made pursuant to a State Hardest Hit Fund program).

DTI Determination (Appendix Q) for QM Status
The July 24/30 amendment modified certain provisions of Appendix Q, which provides the standards for determining a consumer's total monthly debt and income for purposes of satisfying the QM requirements. Appendix Q was amended to:

- Eliminate the requirements that the creditor: (1) examine the consumer's qualifications for an employment position, the consumer's previous professional training and educational background; and (2) examine an employer's confirmation of the consumer's continued employment.
- Eliminate the three-year income verification requirement. The July 24/30 amendment only requires the creditor to determine whether a consumer's income level "can be reasonably expected to continue." Creditors can assume that a consumer's income can be reasonably expected to continue if the consumer's employer verifies current employment and income and does not indicate that employment has been or is set to be terminated.
- Eliminate a creditor's required analysis of whether overtime and bonus income will continue. Such income may be used if the consumer has received it for the past two years and documentation submitted for the loan does not indicate this income is likely to cease.
- Require only the receipt of a Social Security benefit verification letter to verify the receipt and continuance of Social Security income.
- Eliminate certain requirements for ascertaining self-employed consumer income, including the requirements that a creditor: (1) obtain business credit reports for corporations and S-corporations; (2) evaluate sources of the consumer's business income; and (3) evaluate the general economic outlook for similar businesses.
- Modify the language regarding the requirement that a creditor verify trust income, and amend the documentation requirements of notes receivable income.
- Establish that rental income must be reflected in the consumer's tax returns.
- Eliminate the prohibition on the acceptability of income from roommates in a single family property occupied as the consumer's primary residence.

The July 24/30 amendment revised the introduction of Appendix Q to make clear that creditors may refer to other federal agency and GSE guidance that is in accordance with Appendix Q as a resource. In the event that Appendix Q is silent on the treatment of certain debt or income, the creditor can either: (1) exclude the income or include the debt, or (2) rely on federal agency and GSE guidance.

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