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MORTGAGES

The Dodd-Frank Act imposes significant litigation risks on all mortgage originators and lenders unless they only make ''Qualified Mortgages'' or ''QM.'' The Federal Reserve recently issued a lengthy and complex proposed regulation defining a QM. Raymond Natter, of Barnett, Sivon & Natter, P.C., provides a clear explanation of the most significant aspects of the Qualified Mortgage proposal, first with an Executive Summary and then a fuller and more detailed examination of what the proposal means in practice for mortgage originators and lenders.

Fed's Qualified Mortgage Rule: Its Impact on Originators, Lenders, Consumers

BY RAYMOND NATTER

Executive Summary

The Federal Reserve Board published a proposed rule to implement the Qualified Mortgage (QM) provisions of the Dodd-Frank Act on April 19, 2011. Mortgage loans that are not QM are subject to heightened litigation risks and other detriments that will make non-QM lending much more difficult and costly. The QM definition is not the same as the Qualified Residential Mortgage or QRM definition. The QM applies to all residential mortgages, while the QRM only relates to the risk retention required when mortgages are securitized.

While the regulation was issued by the Federal Reserve, the rulemaking authority will transfer to the Bureau of Consumer Financial Protection on July 21, 2011, one day before the comment period closes. Thus the Bureau, and not the Fed, will issue the final docu-

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ment. It's possible that once a Director is appointed, he or she may decide to take a different approach, or even issue a new proposal. If a Director is not appointed, the Secretary of the Treasury asserts the authority to issue a final regulation in this area, but his authority to do so is not without dispute.

The proposal seeks comments on which of two alternatives should be adopted. The first approach would create a legal safe harbor from challenges based on the alleged failure to comply with the ''ability to repay standard.'' The second approach would only create a rebuttable presumption that the creditor satisfied this test. Since a rebuttable presumption can be overcome by a plaintiff through the production of any evidence to the contrary, this alternative is not likely to provide significant protection in a litigation context. Further, even the safe harbor alternative will expose a mortgage lender to liability for failure to comply with any of the rather complex and subjective requirements for the safe harbor.

Under both approaches, a QM loan may not have points and fees in excess of 3 percent of the total loan principal. The regulation defines the term ''total loan amount'' and it is not necessarily the same amount as the total principal borrowed. Thus, the 3 percent cap may be less than 3 percent of the total amount advanced by the lender.

On the other hand, the term'' points and fees'' is defined broadly to include many charges that are not paid to the creditor. For example, all payments to a loan originator are included. If the loan is originated by an employee of the creditor, such as a loan officer of a bank, payments to that loan officer (other than base salary) are also picked up. For example, if the loan officer is paid on an hourly basis, the wages paid for his or her time processing the loan will be added to the points and fees. Payments to an affiliated company providing real estate services (such as title insurance, home inspection, or surveys) are also included as points and fees. The maximum allowed prepayment penalties that may be assessed under the loan are also applied against the 3 percent cap. In short, under the proposed regulation, the 3 percent cap on points and fees will often be less than 3 percent of the amount of the loan, and could become a significant constraint on the ability of mortgage lenders to make QM loans.

Various underwriting standards are required for a loan to be a QM mortgage. The loan must be underwritten on a fully amortizing basis, and in the case of a variable rate loan, the maximum possible interest rate that may be charged in the first five years after consummation must be used for underwriting purposes. Balloon payments are generally not allowed, and a QM may not contain an interest-only payment option, or have a term in excess of 30 years. The regulation contains various requirements regarding the consideration and verification of such items as income, assets, employment, expected earnings, credit history, debt-to-income ratio, residual income, and simultaneous loans. These regulatory standards are complex and technical, thus creating the potential for inadvertent non-compliance with resulting exposure to litigation liability. Further, even if the verification requirements are satisfied, a creditor could still be challenged on whether or not the information obtained was fully and appropriately considered. Thus, even under the safe harbor, it's possible that a plaintiff could allege that the lender failed to properly consider the borrower's financial condition.

Analysis of The Federal Reserve Board's Proposed Qualified Mortgage Regulation

On April 19, 2011, the Federal Reserve Board released a 474 page proposed regulation that, among other things, defines the term ''Qualified Mortgage'' (QM), as that term is used in Section 1412 of the Dodd-Frank Act. The QM should not be confused with the definition of a Qualified Residential Mortgage (QRM). The QM is applicable to all residential mortgages, while the QRM only relates to the amount of risk retention that will be required when a pool of mortgage loans is securitized.

I. Role of the QM Definition in the Dodd-Frank Act

The Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA) uses the term ''Qualified Mortgage'' in several contexts. The most significant relates to the new underwriting requirement imposed by the DFA: a mortgage creditor must make a good faith determination that the borrower has a reasonable ability to repay the mortgage. The term is also used in connection with a new ''steering'' restriction imposed by Section 1403 of the DFA. Third, the term QM mortgage is referenced in the risk retention requirements established in Section 941 of the DFA. Finally, a mortgage loan may not contain a prepayment penalty unless it is a QM loan.

A. *''Ability to Repay'' Underwriting Standard*

Section 1411 of the DFA provides that no creditor may make a residential mortgage loan unless the creditor makes a reasonable and good faith determination, based on documented and verified information, that the consumer has a reasonable ability to repay the loan, and all applicable taxes, insurance and assessments.[1] This determination must be made as of the time the loan is consummated.

In making this determination, the creditor must consider and verify a number of factors, such as borrower's credit history, current income, expected income reasonably assured of being received, current obligations, debt-to-income ratio, employment status, and financial resources other than the real property that secures the loan. The amount of income and assets must be verified by reviewing IRS transcripts of tax returns or another method that effectively verifies income documentation by a third party.

Section 1412 of the DFA, entitled ''Safe Harbor and Rebuttable Presumption,'' provides that the creditor may *presume* that the loan has met the ''ability to repay'' standard if the loan is a ''qualified mortgage.'' The statute lists the minimum qualifications for a QM:

- There is no negative amortization;
- No balloon payments;
- No ability to defer payments of principal, e.g., no ''interest only'' payments;

[1] The ''ability to pay'' requirement does not apply to open-end loans, timeshare plans, reverse mortgages and temporary or ''bridge'' loans with a term of 12 months or less.

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■ Income and financial resources of the borrower are verified and documented;

■ The loan is underwritten based on full amortization and takes into account ''mortgage related obligations'' such as taxes, property insurance and assessments;

■ Variable rate loans are underwritten based on the maximum rate permitted in the first five years;

■ Complies with guidelines and regulations regarding debt-to-income ratio or residual income and other matters;

■ Total points and fees generally do not exceed 3 percent of total loan amount; and

■ The term does not exceed 30 years.

Exceptions from some of these requirements are made for loans made in rural areas and for smaller loans, subject to certain conditions and regulations.

The DFA initially gives the Federal Reserve Board the general regulatory authority to add, subtract, or otherwise revise these statutory requirements for a QM. However, as will be explained below, this authority will transfer to the Bureau of Consumer Financial Protection on July 21, 2011. With respect to FHA, VA, and other government guaranteed loans, the regulatory authority to revise or amend the definition of a QM is given to the respective government departments and agencies, e.g., the Department of Housing and Urban Affairs, the Department of Veterans Affairs, the Department of Agriculture, and the Rural Housing Service.

B. *Anti-Steering Restriction*

Section 1403 of the DFA prohibits mortgage originators from steering customers to a non-QM loan if the customer could obtain a QM loan. For example, even if a consumer specifically asks for a balloon loan, a mortgage originator cannot offer that product if the borrower would qualify for a QM loan that, by definition, cannot have a balloon payment. In order to avoid potential liability for ''steering,'' it is likely that mortgage originators will only recommend QM loans unless very unusual circumstances exist.

C. *Relationship to QRM Definition*

The third reference to qualified mortgage is found in Section 941 of the DFA. This section imposes a ''risk retention'' requirement on securitizers. There are several exceptions to this requirement, including one for mortgages that meet the definition of a ''Qualified Residential Mortgage'' or QRM. A cross reference provides that the definition of a QRM cannot be any ''broader'' than the definition of a QM. However, it is important to recognize that the QM and QRM are different standards, and that while the QM will affect all residential mortgages, the QRM relates only to the securitization process.

D. *Prepayment Penalties*

The DFA states at Section 1414 that a residential mortgage loan may not contain a prepayment penalty unless it is a QM. In addition, even a QM loan cannot have a prepayment penalty if it is a variable rate loan or if it has an annual percentage rate that exceeds certain thresholds. In all cases the prepayment penalty must be phased out over a three year period beginning on the date the loan is consummated.

II. Regulatory Authority After July 21, 2011

The proposed regulation was issued by the Federal Reserve Board. However, the authority to define a QM mortgage will transfer to the Bureau of Consumer Financial Protection as of July 21, 2011. Interestingly, the comment period for the proposed regulation ends on July 22, 2011, which is one day after the Federal Reserve Board's authority is transferred to the Bureau. Thus, although the proposal was drafted by the Board, it will be the Bureau that will consider the comments and issue the final regulation.

It is likely that the Fed staff working on this proposal will be transferred to the Bureau on July 21, and therefore the proposed regulation could represent, more or less, the type of proposal that the Bureau could support. On the other hand, it is possible that when a Director is appointed to the Bureau, he or she may have different views as to what the definition of a QM should encompass. The Bureau might even decide to issue a new proposed regulation that reflects the views of the Director.

Another factor to consider is the authority of the Bureau to promulgate a regulation prior to the appointment of a Director. The Treasury Department takes the position that the Secretary of the Treasury has the authority to promulgate consumer regulations under statutes that are transferred to the Bureau on July 21. The Secretary would likely consider the views of his Special Advisor, Elizabeth Warren, when promulgating the final QM regulation. On the other hand, a cogent argument can be made that the Secretary of the Treasury does not have the statutory authority to issue such regulations. Whether or not that position would be upheld in court, litigation over the rulemaking power of the Secretary of the Treasury could affect the ability of the government to issue a final regulation before a Director is appointed.

III. Main Features of the Proposed Definition of a QM Loan

The proposed regulation elaborates on the statutory definition of a QM, and the Federal Reserve Board makes several changes based on its authority to revise the statutory criteria. The most significant provisions are highlighted below.

A. *Safe Harbor or Rebuttable Presumption*

A preliminary issue raised in the NPR is whether satisfying the QM test establishes a safe harbor from the ''ability to repay'' standard or instead only establishes a rebuttable presumption that the test has been met. The Board's position is that the statute is ambiguous on this question, and therefore proposes two alternatives for public comment. Presumably, the final regulation will contain one of these two options, but not both.

Under the safe harbor alternative, a party cannot raise the ''ability to repay'' issue against the lender if the lender has complied with the requirements for a QM loan. However, even under this alternative a party can allege that the lender failed to comply with the technical requirements for a QM loan, and thus the loan should be subject to attack under the ability to repay standard. For example, a borrower could allege that the lender did not correctly document his or her income, or that the lender properly documented the income, but failed to appropriately *consider* that the level of income in light of other debts. Thus, even under the safe harbor alternative, a lender will have increased litigation risks.

Under the second alternative, compliance with the QM requirements only establishes a ''rebuttable presumption'' that the ''ability to repay'' standard was satisfied, and this presumption can be rebutted by the borrower. This provides little protection from liability, since a rebuttable presumption can be overcome by coming forward with just about any evidence to the contrary, and even a single affidavit signed by the plaintiff may be sufficient.[2]

1. Legal Safe Harbor

The legal safe harbor alternative defines a QM as a loan meeting the following statutory factors:

- There is no negative amortization;
- No balloon payments (except in rural or underserved counties);
- No ability for the consumer to defer payments of principal, e.g., no ''interest only'' payments or ''graduated payment'' loans;
- Income and financial resources of the borrower are considered and verified;
- The loan is underwritten based on full amortization and takes into consideration all mortgage-related obligations, such as taxes, property insurance and assessments;
- Variable rate loans are underwritten based on the maximum rate permitted in the first five years;
- Total points and fees generally do not exceed 3 percent of total loan amount; and
- The term does not exceed 30 years.

However, under the proposal the creditor would not be required to consider and verify the borrower's employment status, the payment of any simultaneous loans that the creditor knows or has reason to know about, the consumer's current obligations, or the borrower's credit history. This alternative does *not* impose a debt-to-income or residual income test.

2. Rebuttable Presumption (''Alternative QM'')

Under the rebuttable presumption alternative, the creditor would have to comply with all of the criteria listed above for the safe harbor option, and, in addition, would have to consider and verify current employment status, the monthly payment on simultaneous loans, current or reasonably expected income, current debt obligations, the borrower's debt-to-income ratio and residual income, and the borrower's credit history. If all of these requirements are met, the creditor would enjoy a ''presumption'' that the ability to repay test was met, but the consumer could still rebut this presumption. As noted above, the presumption can be rebutted by presenting almost any evidence that the borrower did not meet the ''ability to repay'' standard. In light of this fact, the value of a rebuttable presumption alternative as a means to reduce the legal risks in making mortgage financing is questionable.

B. *Points and Fees*

1. Total Loan Amount

Under either QM alternative, points and fees are generally limited to 3 percent of the ''total loan amount.'' The proposal requires certain deductions from the amount extended by the loan, such as the amount of the points and fees financed by the mortgage. Therefore the ''total loan amount'' will often be less than the amount of the loan, and the amount of allowable points and fees will be less than 3 percent of the actual loan amount.

2. Points and Fees: Payments to Third Parties

In calculating ''points and fees'' a creditor may exclude bona fide third party charges to the extent such charges are not retained by the creditor, loan originator, or an affiliated entity of the creditor or originator. For example, if the creditor charges $400 for a loan appraisal, and retains $100 of that amount, paying an independent appraisal company $300, the points and fees for that loan would include the $100 retained by the creditor.

3. Points and Fees: Payments to a Loan Originator

The term ''points and fees'' includes all compensation paid directly or indirectly by a consumer or creditor to a loan originator. It does not matter if the fees are paid before or after the loan closing. The preamble explains that points and fees include compensation paid to a loan originator and *attributable to the particular loan*. Thus, compensation (other than a base salary) paid to an employee of the creditor, such as a loan officer, will be included in the points and fees calculation if the compensation is tied in some way to that loan origination. For example, if an employee is paid an hourly wage, the amount earned by the employee for the time spent on that particular loan will be considered as ''points and fees.'' The regulation does not state if the amount should be the net pay, pay received after taxes and withholdings, or the gross pay including benefits. Other compensation captured in the points and fees calculation are bonuses, commissions, gifts, tips, yield spread premiums, incentive awards, processing fees, and similar items that are based on loan closings

The term ''mortgage originator'' is defined by the Dodd-Frank Act to include any person that assists the consumer in applying for a loan. Therefore, the term ''points and fees'' includes payments to any person (with two exceptions) who assists a consumer in applying for a residential mortgage, including anyone who advises on loan terms, assists in preparing loan documents, or assists in collecting information necessary for the loan application. Even if such services are provided by an independent third party, such as a certified financial planner, any fees paid by the consumer to this third party must be included in the points and fees limit.

These provisions may have the unintended consequence of restricting credit availability for borrowers who need more time and attention in understanding and applying for a loan, since the costs associated with providing additional services will be counted against the 3 percent cap.

4. Exceptions for Licensed Real Estate Brokers and Employees of a Manufactured Home Retailer

Excluded from the definition of points and fees are payments made to a licensed real estate broker, who *only* performs real estate brokerage activities, and who is not compensated by a creditor or loan originator. Also excluded is compensation paid to an employee of a manufactured home retailer who assists a consumer in obtaining or applying for a residential mortgage loan.

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[2] See, e.g., *Randall v. Sorrell*, 548 U.S. 230 (2006), dissenting opinion of Justice Souter.

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5. Mortgage Insurance

Federal or State agency mortgage insurance premiums and guaranty fees are not included in points and fees. Private mortgage insurance premiums paid at or before closing are also excluded, but only up to the amount of the then current FHA premium. The ''up front'' private mortgage insurance premium must be refundable on a pro rata basis and the refund must be issued automatically on notification that the loan has been satisfied. Private mortgage insurance premiums payable *after* loan closing are excluded.

6. Prepayment Penalties

Points and fees also include the maximum prepayment penalty that could be imposed under the mortgage agreement, as well as the amount of any prepayment penalty paid by the consumer on an existing mortgage that is being refinanced by the same creditor or an affiliate of that creditor.

7. Small Loan Adjustment

The proposed rule solicits comments on two possible adjustments of the 3 percent limit for smaller loans. As proposed, the adjustment would only apply to loans of $75,000 or less.

8. Bona Fide Discount Points

In determining if the 3 percent cap has been reached, the creditor may exclude 2 bona fide discount points that reduce the interest rate on the mortgage loan. However, in order to utilize the 2 percent exemption, the interest on the mortgage without the discount points cannot exceed the ''average prime rate offer'' by more than 1 percent. The average prime rate offer will be calculated by the Federal Reserve Board.

If the rate before the discount is more than 1 percent above the average prime rate offer, but is not more than 2 percent above the average prime rate offer, up to 1 bona fide discount point may be disregarded when calculating the points and fees cap.

C. Underwriting Standards

The proposed requirements for a QM state that the creditor underwrite the loan based on a full amortization schedule, and that variable rate loans must also be underwritten based on the maximum rate permitted in the first five years after consummation of the loan.

1. Fully Amortizing

The creditor must make the underwriting determination with the assumption that the loan will be paid off through substantially equal monthly payments of principal and interest over the entire term of the loan, or the periodic payments must pay off the outstanding principal balance as of the earliest date the interest rate can adjust to the maximum interest rate. As noted above, maximum interest rate is the highest rate that may be imposed during the first 5 years after consummation, even if the rate can go higher after the 5 year period.

2. Consideration of Mortgage-Related Expenses

The underwriting process must take into account all mortgage-related expenses, defined to include property taxes, required homeowner's insurance, mortgage insurance, condominium assessments, cooperative fees, ground rent or leasehold payments, special assessments, and similar items. Obligations that are not required, such as credit life insurance, optional earthquake coverage, or debt cancellation fees, do not have to be considered for this purpose.

3. Consideration and Verification of Income and Financial Assets

A creditor must *consider* and *verify* the income, or reasonably expected income, and financial assets of the borrower. Income and assets that may be considered do not include the dwelling securing the loan . As drafted, the proposal is not entirely clear if the creditor may consider the potential rental income from a basement apartment, or from the units in a four family dwelling that will not be occupied by the borrower. If the intent is to permit consideration of such income, the language should be modified to make this clear.

Verification requires the use of tax records or third party documents that provide reasonably reliable verification of income and financial resources. The proposed regulation provides further discretion to rely on such items as copies of tax returns filed with the Federal or State taxing authorities, W-2s and similar IRS forms reporting income, payroll statements, bank records, and records from the applicant's employer, government benefit records, check cashing receipts, receipts from the consumer's use of fund transfer services. For self-employed, the proposal would permit a creditor to rely on a profit and loss statement that has been reviewed by an independent accountant. With respect to expected income, the creditor must rely on third party records that provide reasonable assurance of the expected income, such as written assurances from an employer indicating that the borrower will be entitled to a raise or will assume a new position upon completion of a training program.

The proposal requires both *verification* and *consideration* of these factors. This leaves open the possibility that even if the financial data is verified properly, a plaintiff may allege that the lender failed to properly *consider* the significance of such information.

3. Employment Status

Under the Alternative QM, the creditor must also *consider* and *verify* the borrower's employment status. Creditors are to rely on reasonably reliable third party records to verify employment, but such verification may be oral. Employment in the military may be verified using the Department of Defense on-line database. This requirement also raises the potential that a claim may be based on failure to appropriately consider employment status, for example the fact that the borrower was in a probationary period, or that the employer was in a downsizing process.

4. Monthly Payment on Simultaneous Loans

Also under the Alternative QM, the creditor must *consider* and *verify* the borrower's monthly payments on simultaneous loans that the creditor knows of or has reason to know will be made to the consumer. A simultaneous loan is a loan, including a Home Equity Line of Credit, which is secured by the same dwelling as the mortgage, and is made at or before consummation of the mortgage. If the creditor learns about the simultaneous loan, the terms of that loan must be verified, for example, by obtaining a copy of the promissory note.

5. Current Debt Obligations

Another factor that must be *considered* and *verified* under the Alternative QM is current debt obligations of

the borrower. The proposed regulations state that a credit report may be used for this purpose. Creditors may refer to the FHA's handbook on mortgage credit analysis to determine what constitutes a ''debt.'' Examples include student loans, credit card debt, automobile loans, alimony, child support obligations, and existing mortgages. In addition to credit reports, verification of such debts may be obtained from loan statements and court orders.

The proposal solicits comments on the appropriate treatment of debts that are almost paid off, debts that are in forbearance or deferral, and the treatment of debts owed by a joint applicant.

This requirement also raises the potential that a plaintiff could allege failure to appropriate consider such debts.

6. Credit History

The proposed Alternative QM requires the creditor to *consider* and *verify* the applicant's credit history. The proposed regulation explains that this will provide information that the creditor should use to determine the borrower's *willingness* to repay, and not just ability to repay. Factors that the creditor should consider are the number and age of credit lines, payment history, judgments, collection actions, and bankruptcies. Creditors may rely on credit reports, as well as third party documents, such as rental payment history or public utility payments. As noted above, this factor might expose lenders to liability for failure to appropriately consider the applicant's credit history.

7. Debt-to-Income Ratio or Residual Income

The Alternative QM requires the creditor to *consider* the applicant's debt-to-income ratio or residual income after paying mortgage and non-mortgage obligations. The proposal does not include a specific ratio, but only requires that this factor be considered by the creditor. The failure to specify a ratio may leave the door open for plaintiffs to allege that the lender failed to appropriately consider the debt-to-income ratio or amount of residual income.

D. *Balloon Payments*

A balloon payment is defined by the proposed regulation as a scheduled loan payment that is more than twice as high as a regular periodic payment. The only exception is for loans made in rural or underserved counties that meet certain other requirements. The proposal solicits comments on whether balloon payments that include provisions for automatic renewal of the loan at the consumer's option should be treated differently.

E. *Prepayment Penalties*

A prepayment penalty is a charge imposed for paying all or part of the principal of a mortgage loan before the date on which it is due. For example, it includes the imposition of a fee for providing loan release documents that would not be charged if the loan was not paid off early. It also includes charging interest on a loan based on the amortization schedule and not the actual amount of outstanding principal. Certain QM loans may include a prepayment penalty during the first three years of the loan.

F. *Thirty-year Term*

A QM may not have a loan term in excess of 30 years. The proposal solicits comment on whether the term should be extended in high-cost areas.

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