Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

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What Happens if a Mortgage Is Not a QM Loan?[*]

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Beginning on January 10, 2014, all residential mortgage loans must comply with the new underwriting standards required under the Dodd-Frank Act and CFPB regulations. One of the most significant of these new requirements is the so-called "ability to repay" rule. The rule states that no residential mortgage loan may be made unless the creditor has made a reasonable and good faith determination that, at the time the loan is consummated, the consumer has a reasonable ability to repay the loan, according to its terms, and all applicable taxes, insurance and assessments. The CFPB has made it clear that this is a subjective determination that will depend upon all of the facts and circumstances of each individual loan.[1]

In order to provide a bright line test that creditors can rely upon when making residential mortgages, the CFPB has defined the attributes of a "qualified mortgage" or "QM." Most loans that meet the definition of a QM loan are deemed to meet the "ability to repay" standard. Higher cost loans (loans with an APR that is 1.5 percent or more above the average prime rate offer for a first mortgage loan) that meet the QM standard are granted a presumption of meeting the "ability to repay" requirement, but this presumption may be rebutted by the borrower. Although the intent was to provide a bright line test, the QM regulation is so complex that an inadvertent failure to comply with the QM requirements may become a significant problem. This article will discuss the possible legal risk that a lender will have if it chooses to make a non-QM loan, as well as the potential risks that might arise if a lender intends to make a QM loan but inadvertently makes a non-QM loan. It is important to note that for non-QM loans, a lender may find it very difficult to avoid a trial if compliance with the repay test is raised, since such compliance is very much fact specific. Therefore, a judge will be disinclined to grant a motion for a summary judgment without first hearing all of the evidence regarding the underwriting of the loan and

[*] The information contained in this newsletter does not constitute legal advice. This newsletter is intended for educational and informational purposes only.

[1] See 78 Fed. Reg. 6603-04 (2013).

the borrower's particular situation. This may increase the likelihood that failure to comply with the ATR test will be raised routinely in disputes with mortgagors, and will also increase the likelihood that lenders will want to settle before the expense of an evidentiary trial is incurred.

Below is a list of the risks that arise when a non-QM loan is originated or purchased.

A. Administrative Enforcement Action

A Federal banking agency or the CFPB may bring an enforcement action against any institution within the agency's respective jurisdiction[2] on the basis that the institution made one or more mortgages without first making a reasonable and good faith determination that the consumer had a reasonable ability to repay the loan. Potential penalties include the issuance of a cease-and-desist order against the lender, or a civil money penalty of up to $5,000 per day for unintentional violations. For more serious infractions, the amount of the civil money penalty could exceed $1 million per day if the violation was committed "knowingly." An enforcement action will be sustained if the agency satisfies the "preponderance of the evidence" standard.

B. Criminal Liability

Any person that willfully and knowingly makes a mortgage loan without first making a reasonable and good faith determination that, at the time the loan is consummated, the consumer has a reasonable ability to repay the loan shall be subject to a criminal fine of up to $5,000 or imprisoned for not more than one year, or both. Conviction requires proof beyond a reasonable doubt.

C. Civil Suits by Individual Borrowers

Any mortgagor has up to three years from the date on which the loan closes to bring a civil action against the lender on the basis that the lender failed to make a reasonable and good faith determination that the borrower had a reasonable ability to repay the loan when it was made. Statutory damages are established as the sum of:

(i) Any actual damage caused by the violation;

[2]The Federal banking agencies have enforcement jurisdiction for institutions with $10 billion or less in assets.

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(ii) Twice the amount of the finance charge up to $4,000;

(iii) The actual amount of any finance charges or fees paid by the consumer, unless the creditor demonstrates that the failure to comply is not material; and

(iv) If the plaintiff is successful, the costs of the litigation and mortgagor's attorney fees.

D. Class Action Liability

In the case of a class action, the amount of recovery is set by the court, except that the total recovery arising from the same failure to comply is capped at the lesser of $1 million or one percent of the net worth of the creditor. Arguably, since each loan made in violation of the ATR standard is a separate violation, the cap works out to equal $1 million for each member of the class, or one percent of the lender's net worth.

E. Actions by State Attorneys General

An "appropriate" State Attorney General may bring a civil action against a lender for failure to comply with the ATR requirement, within three years after the loan is made. The State Attorney General must provide prior written notice of any such civil action to the Federal agency responsible for enforcement. The Act would apparently permit a State Attorney General to bring a civil action against a lender across State lines, if the loan is made to a resident of the State in which the Attorney General has been appointed or elected to serve.

F. Defense to Foreclosure Against Creditors and Assignees

At any time, a mortgagor may raise the allegation that the original creditor did not make a reasonable and good faith determination that the borrower had a reasonable ability to repay the loan at the time the loan was made as a defense in any foreclosure or other proceeding to collect the mortgage debt. This defense may be raised against the original creditor or any assignee or other holder of the loan. If the consumer is successful, the amount that the consumer would have been entitled to had he or she brought a civil action within the three year time limit, plus reasonable attorney fees, will be used to reduce the amount of debt owed to the plaintiff in the foreclosure or debt collection proceeding. Since statutory damages include the total amount that the consumer has paid in interest and fees, the longer the loan has been in place, the larger the amount of recoupment due to the consumer who's fighting the foreclosure.

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G. Federal and State Securities Laws

Lenders that inadvertently make non-QM loans, and sell them into securitizations asserting that they are QM qualified, will face considerable liability under Federal and State securities laws if the loans are later determined to be non-QM. This is especially true under many State Blue Sky laws that impose civil liability even for unintentional material misstatements.

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