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

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The Mysterious Clause 5*

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On January 10, 2014, the final regulation implementing the Dodd-Frank Act's "ability to repay" provisions went into effect, along with the Consumer Financial Protection Bureau's regulation creating a "safe harbor" for "qualified mortgages."[1] As was pointed out in an article published in last month's Perspectives, making a mortgage loan that is not a QM loan can create legal risks for the lender as well as for anyone who purchases the loan, including for purposes of securitization. While some lenders will be willing to assume these risks, many others will want to make sure that their mortgages conform to the requirements of a QM. However, this may not be as easily done as one would hope, and unfortunately, we may have to await court decisions before the exact parameters of the QM rule are fully understood.

This quandary can be illustrated by what I call the "mysterious clause 5." Various conditions must be met for a loan to be considered a qualified mortgage. For non-conforming loans[2] one of the requirements is that at or before closing, the lender must *consider* and verify the consumer's current or reasonably expected income or assets (other than the home serving as collateral for the mortgage) and the consumer's current debt obligations, alimony, and child support.[3] This requirement is different from, and independent of, another provision that caps the consumer's debt-to-income ratio at closing to 43 percent.[4]

The key problem in clause 5 is that the lender must not only verify, but

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[1] For higher cost loans, meeting the QM standard creates a rebuttable presumption of compliance with the ability to repay standard.

[2] Loans that are not eligible for purchase by Fannie or Freddie, or for insurance or guarantee issued by a Federal agency.

[3] 12 C.F.R. §1026.43(e)(2)(v).

[4] 12 C.F.R. §1026.43(e)(2)(vi).

also "consider" the consumer's debts and income. Further guidance on what is required as part of this process of "considering" the borrower's income and debt is not provided in the regulatory material. It is possible that a lender will be deemed to have "considered" the consumer's income and debts by simply noting these amounts in the loan file. However, there is some case law indicating that a lender must do something more, and show that a meaningful analysis was conducted. For example, a California court held that the term "consider" means to think about the topic with a degree of care or caution and to treat it in an attentive way. The court concluded that the California Forest Service failed to consider certain required factors because it failed to discuss those factors in its timber harvesting plan. (*Ebbets Pass Watch v. California Department of Forestry and Fire Protection*). In a Rhode Island case, the superior court found that the term "to consider" means "to think carefully about" and that the term suggests objective reflections and reasoning. (*Raito v. Cardi Corporation*, Superior Court decision). A lower court in New York stated that "to consider a proposition of any kind means to think about it, to reflect upon it or ponder it. (*People v. TruSport Pub. Company*).

Whether a court would mandate some evidentiary showing that a lender actively "considered" a consumer's income and debts as required by clause 5 is an open question. It is possible that merely noting these factors would be sufficient. However, if that interpretation is upheld, it could be viewed as effectively removing the word "consider" from the regulation, which is not typical of judicial interpretation of regulatory language.

In addition, it should be noted that the CFPB guidance that accompanies the QM definition states that the income and debts that must be verified and considered under clause 5 may include income and debts that are not part of the 43 percent debt-to-income ratio. This implies that something more was intended in clause 5 than just verifying the data to be used in the 43 percent ratio.

It is also important to remember that the CFPB does not enforce compliance with the QM definition. Whether or not a loan is a valid QM loan will be resolved in litigation, most likely when a borrower raised failure to comply with the ability to repay test as a defense to a foreclosure action.

Thus, it will be the courts that ultimately interpret the meaning of the regulation. But a court will be greatly influenced by CFPB interpretive guidance. Thus, the CFPB has an opportunity to clarify the meaning and requirements of clause 5, as well as other provisions in the QM rule. I would strongly suggest that the CFPB solicit questions about the regulation from the public, and then publish an official "question and answer" document that would represent the agency's official position of interpretive concerns. If lenders understand the requirements, they can choose whether or not to make a QM loan. What should be avoided is a surprise court interpretation of the regulation that no lender anticipated.

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