

The New Ability-to-Pay Rules; Qualified Mortgage Lending under the Dodd-Frank Act

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Augmented Underwriting Requirements

A. Definition of Mortgage Originator

As a threshold matter, Section 1401 of Dodd Frank amends the federal Truth-in-Lending Act (“TILA”) to define the term “mortgage originator” (a mortgage broker in this context) as:

Any person, who for direct or indirect compensation,

- (i) takes a residential mortgage loan application;
- (ii) assists a consumer in obtaining or applying to obtain a residential mortgage loan; or
- (iii) offers or negotiates terms of a residential loan.

Notably, the Act excludes from the definition, among other things:

- (i) persons who perform “purely administrative or clerical tasks;” or
- (ii) persons who only perform real estate brokerage activities provided that they are properly licensed;
- (iii) persons who make three or fewer purchase money loans in any 12 month period that are fully amortizing and where the borrower has a reasonable ability to repay the loan.



B. Standards for Mortgage Loan Origination - ABILITY TO REPAY

The centerpiece of Section XIV is an amendment to TILA that would mandate that consumers be offered loans that “reasonably reflect their ability to repay...and that are understandable and not unfair, deceptive or abusive.” The amendment also requires originators to be appropriately licensed under applicable federal and state law, adhere to the requirements of the Secured and Fair Enforcement for Mortgage Licensing Act of 2008 (“SAFE Act”) and include on all loan documents the originator’s unique identifier as mandated by the SAFE Act.

C. Prohibition on Steering

Section 1403 of the Act prohibits mortgage lenders and brokers from giving or receiving compensation that varies based on the terms of the loan (other than the amount of the principal). ***This provisions essentially prohibits the payment of yield spread premiums for the referral of a loan to a lender at a higher than par interest rate.***

The provision does not, however, prohibit payments to lenders that are ultimately passed on third parties for bona fide charges not retained by the lender, broker or any of their affiliates. Further, the provision does not impact compensation that secondary market purchasers pay for closed loans.

Section 1403 directs the newly created Bureau of Consumer Financial Protection (the “Bureau”) to prescribe regulations to prohibit mortgage originators from steering any consumer to a residential mortgage loan that:

- (i) the consumer lacks a reasonable ability to repay;
- (ii) has predatory characteristics or effects (such as equity stripping, excessive fees or abusive terms);
- (iii) is a non-qualified mortgage when the consumer was eligible for a qualified mortgage; and
- (iv) have abusive or unfair lending practices that promote disparities among consumers of equal credit

worthiness but of different race, ethnicity, gender or assets.

Further, the Act prescribes that these regulations also prohibit mortgage originators from:

- (i) mischaracterizing the credit history of a consumer or the residential mortgage loans available to a consumer;
- (ii) mischaracterizing or subordinating the mischaracterization of the appraised value of the property securing the extension of credit;

and

(iii) discouraging a consumer from seeking a home mortgage loan secured by the consumer's principal dwelling from another originator if unable to suggest, offer or recommend to a consumer a loan that is not more expensive than a loan for which the consumer qualifies.

The Act makes clear that Section 1403 shall not be construed as:

(i) permitting any yield spread premium or other similar compensation that would, for any mortgage loan, permit the total amount of direct and indirect compensation from all sources permitted to a mortgage originator to vary based on the terms of the loan (other than the amount of the principal);

(ii) restricting a consumer's ability to finance, at the option of the consumer, including through principal or rate, any origination fees or costs permitted under this subsection, or the mortgage originator's right to receive such fees or costs so long as they do not vary based on the loan terms (other than the amount of the principal) or the consumer's decision about whether to finance such fees or costs; or

(iii) prohibiting incentive payments to a mortgage originator based on the number of residential mortgage loans originated within a specific period of time.



D. Liability for Violations of Duty of Care and Steering Provisions

Mortgage originators who violate the duty of care and steering provisions are subject to liability under TILA in an amount up to the *greater of* actual damages or an amount equal to three times the total of direct and indirect compensation or gain earned by the mortgage originator in connection with the loan involved in the violation, plus the costs to the consumer of the action, including a reasonable attorney's fee.

E. Minimum Standards for Mortgages

Section 1411 directs the Bureau to issue regulations prohibiting creditors from making residential loans unless the creditor makes a reasonable and good faith determination based on verified information that, at the time the loan is consummated, the consumer has a reasonable ability to repay the loan, according to its terms, all applicable taxes and insurance (including mortgage guarantee insurance), and assessments.



F. Multiple Loans

Section 1411 mandates that if the creditor knows or has reason to know, that one or more residential mortgage loans secured by the same dwelling will be made to the same consumer, the creditor shall ensure that the consumer has a reasonable ability to repay the combined payments of all loans on the same dwelling.

G. Basis for Determination

In order to determine a consumer's ability to repay a residential mortgage loan under this subsection, the creditor must consider the consumer's credit history, current income, expected income the consumer is reasonably assured of receiving, current obligations, debt-to-income ratio or the residual income the consumer will have after paying non-mortgage debt and other mortgage-related obligations, employment status, and other financial resources other than the consumer's equity in the dwelling or real property that secures repayment of the loan.

H. Income Verification

The Act mandates that in determining repayment ability, the creditor must review W-2's, tax returns, payroll receipt, financial institutions records or other third party documents that provide reasonably reliable evidence of a consumer's income or assets. Loans guaranteed or insured by federal departments and agencies are eligible for streamlined refinancings if certain criteria are satisfied. In addition, the provisions do not apply to bridge loans with a term of 12 months or less or reverse mortgages.

I. Safe Harbor and Rebuttable Presumption

Creditors and their assignees are subject to a rebuttable presumption of compliance with the Ability to Repay provisions and a corresponding exemption from liability if the mortgage originated is a Qualified Mortgage. Section 1412 defines “Qualified Mortgage” as: any residential mortgage loan with the following features:

- (i) subject to limited exceptions, no negative amortization or balloon payments;
- (ii) income and financial resources were verified and documented;
- (iii) in the case of a fixed rate loan, the underwriting process is based on a payment schedule that fully amortizes the loan over the loan term, taking into account taxes and insurance;
- (iv) in the case of an adjustable rate loan, for which underwriting is based on the maximum rate permitted for the first 5 years, and a payment schedule that fully amortizes the loan over the loan term and takes into account all applicable taxes and insurance;
- (v) complies with all Federal Reserve Board pronouncements relating to debt-to-income ratios;
- (vi) the total points and fees payable in connection with the loan do not exceed 3 percent of the total loan amount (see discussion below);
- (vii) subject to certain exceptions, the term of the loan may not exceed 30 years;
- (viii) unless exempt, reverse mortgages that satisfy the standards of a qualified mortgage.

J. Calculation of 3% Points and Fees

For purposes of computing the total points and fees under this section, the following of either fees, but not both, are excluded from the calculation:

- (i) up to and including 2 bona fide discount points payable by the consumer in connection with the mortgage, but only if the interest rate from which the mortgage's interest rate will be discounted does not exceed by more than 1 percentage point the prime rate offer rate;^[1] or
- (ii) unless bona fide discount points have been excluded under (i) above, up to and including 1 bona fide discount point payable by the consumer in connection with the mortgage, but only if the interest rate from which the mortgage interest rate will be discounted does not exceed by more than 2 percentage points the average prime offer rate.

The legislation authorizes the Bureau to adjust the criteria that define a “Qualified Mortgage Loan” to protect further consumer's interests.

K. Defense to Foreclosure

Borrowers may assert a defense to foreclosure in either a judicial or non-judicial action – brought by the creditor or its assignees if the creditor violated the anti-steering and ability to repay provisions.

[1] The term “average prime offer rate” means the average prime offer rate for a comparable transaction as of the date on which the interest rate for the transaction is set as published by the Federal Reserve Board.

L. Additional Standards and Requirements

Prepayment Penalties

Residential mortgage loans that are not qualified mortgages may **not** contain prepayment penalties. For qualified mortgage loans, prepayment penalties must conform to the following limitations:

- (i) during the first year of the loan, the penalty may not exceed 3% of the outstanding balance of the loan;
- (ii) during the second year of the loan, the prepayment penalty may not exceed 2% of the outstanding balance of the loan;
- (iii) during the third year of the loan, the prepayment penalty may not exceed 1% of the outstanding balance of the loan;
- (iv) after three years, no prepayment penalty may be charged.

For qualified mortgages, the creditor must not impose a prepayment penalty on a loan without offering the consumer the option of a loan without a prepayment penalty.

M. Single Premium Credit Prohibition

Like many state anti-predatory lending laws, the Act prohibits creditors from financing single premium credit insurance products except on a monthly basis. Credit unemployment insurance is not subject to this restriction as long as the premiums are reasonable, the creditor receives no direct or indirect compensation, and the premiums are paid pursuant to another insurance contract and are not paid to an affiliate of the creditor.



N. Arbitration

The Act prohibits all residential loans and home equity lines of credit secured by principal dwellings from requiring arbitration provisions.

O. Negative Amortization

Creditors may not make any residential loan secured by a dwelling other than a reverse mortgage with negative amortization unless certain requisite disclosures are given, and in the case of a first-time borrower of a non-qualified mortgage, rights to receive counseling from a HUD-certified counselor.

P. Protection Against Loss of Anti-Deficiency Protection

The Act requires creditors making loans to borrowers in states that have enacted anti-deficiency laws to notify consumers prior to closing about the protection and apprise them of the significance of the loss of such protection.



Q. Policy Regarding Partial Payments

In the case of any residential mortgage loan except timeshare plans, the creditor must disclose to the consumer before settlement its policies regarding the acceptance and application of partial payments.

R. Amendments to Civil Liability and Statutes of Limitation Provisions

Section 1416 increases the statutory civil liability for violations of TILA for open-end credit from its current \$100 – \$1,000 for individual actions to \$200 – \$2,000; and with respect to both open end and closed-end credit, it increases the possible statutory exposure to class action civil liability from the current \$500,000 to \$1,000,000.

Further, the statute of limitations for bringing civil claims under the new steering and ability to pay provisions has been expanded to three years, beyond the current 1 year statute.

S. Lender Rights in the Context of Borrower Deception

Section 1417 shields creditor and assignees from civil liability if the borrower has been convicted of obtaining the residential mortgage loan by actual fraud.

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