The Reconstruction of Mortgage Lending – The Impact of the New CFPB and GSE Reform

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Tom is a corporate counselor, regulatory advisor, litigator and deal maker who has represented a wide variety of financial services clients before federal financial regulators and the Department of Justice on matters ranging from mergers and acquisitions, enforcement, fair lending, litigation, GSEs and corporate governance. He served in the Reagan Administration as General Counsel of the Federal Home Loan Bank Board and the FSLIC, and prior to that, he served in the Office of the Comptroller of the Currency as Special Assistant to the Chief Counsel and Senior Trial Attorney. He has been recognized over the years by *Chambers USA* as “one of the best financial services lawyers in America,” and someone who his clients say “brings unparalleled experience and judgment to difficult decision-making both as a deal-maker and regulatory guru.” He was named in 2013 as one of Washington, D.C.’s 100 Best Lawyers.
Executive Summary

- The CFPB’s mortgage origination rules have changed the disclosure-based system of liability to a suitability-based system
  - the lender must prove the loan should have been made
- The decision risk matrix for lenders has been changed
- A risk analysis is now necessary to make decisions about the mortgage product options lenders should offer to
  - maximize repayment of the loan
  - minimize the lender’s legal liabilities, and
  - avoid collateral liability, such as fair lending claims
Executive Summary (cont’d)

- The value of the QM “safe harbor” and “rebuttable presumption” protections is unknown
  - can only be quantified after a reasonable amount of challenges and judicial decisions
- CRA and fair lending risks make implementation of the ATR/QM rules an even more challenging
- Securitization standards will impose a separate layer of standards on mortgage products
- Lender concern over the value of non-QM loans will reduce credit availability creating new and inconsistent economic and regulatory pressures on lenders
These challenges present distinct opportunities for lenders to enhance their competitive advantage by understanding and quantifying the risks and value propositions of various mortgage programs.
New Risks in Mortgage Lending

- CFPB Fair Lending Enforcement
- Bank Regulatory Safety and Soundness
- Customer Claims for Damages
- CFPB ATR Enforcement
- DOJ, HUD and Other Discrimination Suits
- Customer Non-Payment Defenses
- Secondary Market & Liquidity
- CRA Requirements
- Customer Challenge Under Fair Lending
ATR & QM Requirements

- **SUITABILITY STANDARD**
  CFPB Mortgage Rules establish a suitability standard for residential mortgage loans

- **LEGAL PROHIBITION**
  Lenders are prohibited from making a mortgage loan unless the lender makes a reasonable and good faith determination that the consumer will have a reasonable ability to pay the loan according to its terms.

- Suitability forges a critical change in the law and the balance between a lender and a borrower

- Evidence that may be determinative of that decision
  - Timely payments for a significant period after consummation
  - Default shortly after consummation

- Other factors supporting ATR challenges:
  - Underwriting standards that have historically resulted in comparatively high or low defaults during adverse economic conditions
  - Underwriting standards based on empirically derived, statistically sound models
  - Evidence of insufficient residual income disregarded

- Is a non-ATR compliant loan ultra vires?
CLAIMS FOR DAMAGES
There are significant bases for lender liability and collection difficulties

- General Truth in Lending Act damages available
- Special ATR statutory damages up to sum of all finance charges and fees paid by the consumer may be sought
- Added difficulties in pursuing foreclosure
- Recoupment or setoff can be used against foreclosure
- Leverage to seek a resolution that leaves the borrower in possession of the property on new loan terms
ATR & QM Requirements

- **ATR REQUIREMENTS**
  Lender must consider specified credit-related factors in determining ATR.
  - Income and assets
  - Employment status
  - Monthly payment obligations
  - Debt, alimony and child support obligations
  - Credit history

- **VERIFICATION REQUIREMENTS**
  Lender must verify specific information
  - Income information relied upon
  - Employment status
  - Obligations
  - Income information relied upon
Major Risks for Lenders Under the New Rules

- Compliance with requirements of ATR/QM rules, including examination risk.
- An increased risk of non-repayment and claims for damages.
- Increased chances of a challenge by the government or third parties under evolving fair lending laws.
- A potential diminishment in value and liquidity of the mortgage portfolio.
- Evolving standards and requirements of the secondary market and collateral lenders.
MAGIC OF QM LOANS
How do you construct a QM loan and get the additional legal protection the Rule purports to provide?

How do “Safe Harbor” QM loans and “Rebuttable Presumption” QM loans differ?

QM loan requirements –

- Regular periodic payments that are substantially equal.

- Term no longer than 30 years.

- No excessive points and fees (3% or less of the total loan amount for a loan of $100,000 or more)

- Underwriting to maximum rate during the first five years of the loan

- Periodic payments in first five years will repay outstanding principal balance or loan amount over the term of the loan at the maximum applicable interest rate

- Lender must consider and verify reasonably expected income and assets and current debt obligations,

- Borrower’s total monthly DTI ratio 43% or less
Lender Protections

- **“SAFE HARBOR” QM LOANS**

- **QM Safe Harbor loan characteristics**
  - First lien loans with less than 1.5% (or 3.5% for subordinate lien loans) higher than the average prime offer rate (APOR)
  - QM compliant

- **“REBUTTABLE PRESUMPTION QM LOANS”**

- **Key issues likely to be points and fees cap and DTI calculation**

- **Rebuttable Presumption loan characteristics**
  - First lien loans 1.5% (or 3.5% for subordinate lien loans) or higher than the APOR
  - QM compliant
VALUES OF “SAFE HARBOR” AND “REBUTTABLE PRESUMPTION” PROTECTIONS
In the real world, will these standards protect the lender from unfounded non-payment defenses and claims for damages?

Borrower can challenge and assert a string of non-compliance with requirements of the rule that will
- Require discovery
- Expose lender to litigation costs
- Create leverage for the borrower

Will borrowers’ counsel simply stipulate that loans are “safe harbor” or “rebuttable presumption” loans?

Are discovery and consumer arguments really curtailed or avoided?

Can the lender demonstrate conformity to ATR requirements if “safe harbor” or “rebuttable presumption” standards are not met?
Government-Related QM Loans

These loans must meet the rule’s requirements

- Regular equal periodic payments
- No negative amortization
- No deferral of principal repayment
- No balloon payment
- Term of no longer than 30 years
- No excessive points and fees (those exceeding 3% of the total loan amount for a loan of $100,000 or more)
- Not subject to the 43% DTI limit
- Eligible to be purchased, guaranteed, or insured by Fannie Mae and Freddie Mac (GSEs) (while they remain in conservatorship), or other governmental entities until January 2021
- Subject to either safe harbor or rebuttable presumption based on pricing

Lender Protections
Small Creditor QM Loans

- Total assets of $2 billion origination of 500 or fewer first lien mortgages during the preceding calendar year
- First and subordinate lien loans with a rate of less than 3.5% higher than the APOR
- QM compliant, except the 43% DTI requirement and standards in Appendix Q.
- Lender verification of consumer’s monthly DTI, residual income and DTI debt obligations
  - Loan would lose its QM status if it is held in portfolio for less than three years, subject to certain exceptions
  - CFPB views regarding small creditor “relationship lending”

Lender Protections
Lender Protections

- **Small Rural or Underserved Area Creditor Balloon QM Loans**

  Small rural or underserved area creditor may qualify balloon loan as a QM loan if it meets the following requirements:

  - No negative amortization feature
  - No deferral of repayment of principal
  - No balloon payment, except as permitted under the balloon exception
  - Term of 30 years or less
  - No points and fees in excess of general QM loan limits
  - Verification of income, obligations and ability to make scheduled payments (ex balloon payment) from current or reasonably expected income or assets (other than the property securing the loan)
  - Substantially equal scheduled payments
  - Amortization period of 30 years or less
  - Interest rate that does not increase over the term of the loan
  - Loan term of five years or longer
Lender Protections

- **Small Rural or Underserved Area Creditor Balloon QM Loans**
  - Held in portfolio for three years or more
  - First lien and subordinate lien loans with rate of less than 3.5% higher than the APOR
  - Creditor must meet small creditor requirements
  - Creditor must have extended more than 50 percent of its total mortgages secured by properties that are in rural or underserved areas
  - Available for qualifying loans made by a small creditor that does not meet rural or underserved requirements on or before January 10, 2016
## New Risks & Responses

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<thead>
<tr>
<th>Risk</th>
<th>Response</th>
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<tbody>
<tr>
<td>Increased borrower defenses to payment and affirmative bases for damages</td>
<td>Risk analysis is required since mortgage product choices impact mortgage portfolio values and lender liability</td>
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<td>Management evaluation must be on the record to be useful as a defense (e.g., disparate impact “business necessity” defense)</td>
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<td>Board must consider lending policies based on management recommendations</td>
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<td>Underwriting policies should assume increased non-payment and foreclosure hurdles</td>
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## New Risks & Responses

<table>
<thead>
<tr>
<th>Risk</th>
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<tbody>
<tr>
<td>Conformity of underwriting standards to CFPB mortgage rules</td>
<td>Develop timeline for January 2014 target which</td>
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<td>- Evaluates product risks</td>
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<td>- Chooses acceptable risk products</td>
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<td>- Establishes underwriting standards</td>
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<td>- Legally stresses the products, process and servicing to identify potential challenges and risks</td>
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New Risks & Responses

Risk

- What fair lending challenges can be asserted based on product choices and impact on range of qualified buyers
  - Will non-QM loans be made?
  - What is the result and impact on protected classes?

Response

- Review agency actions, policies and positions
  - Mt. Holly case before Supreme Court
  - Luther Burbank Savings case
  - HUD February 2013 Rule; CFPB Guidance April 2012

- Stress test portfolio for legal challenges
  - Underwriting
  - Processing
  - Rates
  - Conditions
  - Terms
  - Servicing

- Establish “business necessity” of lending policies on the record
New Risks & Responses

**Risk**

- What fair lending challenges can be asserted based on product choices and impact on range of qualified buyers
  - Will non-QM loans be made?
  - What is the result and impact on protected classes?

**Response**

- Document the corporate record
  - Substantiate mortgage products offered
  - Sources of risk
  - Identify “business necessity”
  - Identify challenges and defenses
  - Consider responsive program modifications
  - Consider ways to mitigate damage claims before they are brought
New Risks & Responses

**Risk**
- CRA compliance may be effected by choice of loans offered
  - Limiting loans to QM “safe harbor” may impact CRA factors

**Response**
- Consider impact in various lending areas
- Communicate with regulators
- Expand use of government-related loans
- Improve CRA rating under investment test or otherwise
New Risks & Responses

Risk

- An inability to sell residential mortgage loans or use them as collateral may impact the value of loans and the capital adequacy and profitability of the business

- Various secondary market partners have yet to determine underwriting standards, representations and warranties and repurchase standards

- The FHFA directed GSEs to limit their mortgage loan purchases to QM loans
  - As of January 10, 2014, cannot purchase any loans if they are subject to the ATR Rules and are:
    - Negative amortization or interest-only loans;
    - Loans with a term in excess of 30 years; or
    - Have points and fees in excess of 3% of the total loan amount

Response

- Consider the extent lender will sell, securitize or collateralize mortgage loans
- Consider Fannie and Freddie requirements and impact on lending, CRA and disparate impact
- Determine need to use mortgage loans as FHLB collateral and standards FHLBs will establish
- Consider representations and warranties now that private parties may consider in the future
- Document “business necessity” of policies
- Develop contingent liquidity plans in the event that the marketability or collateral value of certain types of loans is reduced
New Risks & Responses

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<tbody>
<tr>
<td>Will securitization markets accept all mortgage loans?</td>
<td>Evaluate and document range of risks and responses</td>
</tr>
<tr>
<td>What will standard representations, warranties and terms require of</td>
<td>Consider likely exceptions (e.g., QMs, loans eligible for</td>
</tr>
<tr>
<td>origination be?</td>
<td>purchase by Fannie &amp; Freddie) and their impact on policies</td>
</tr>
<tr>
<td>How will the 5% risk retention securitization requirement impact the</td>
<td>Consult with RMBS experts about terms, etc.</td>
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<tr>
<td>nature and quality of residential mortgage loans?</td>
<td>Consider QRM reproposal and required elements</td>
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### New Risks & Responses

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<tr>
<td>Capacity of vendors to create programs, processes and systems by January 2014</td>
<td>Vendors should identify practical options, modifications required and implementation plans</td>
</tr>
<tr>
<td>Oversight and monitoring of vendors</td>
<td>Lender establishes priorities and timelines</td>
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<td>Develop contingency plans</td>
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<td>Consider costs and priorities</td>
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<td>Stress test systems for potential defects and legal challenges</td>
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<td>Document process in the corporate record</td>
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<tr>
<td>How will the mortgage choices made impact</td>
<td>Consider value proportion for mortgage lending</td>
</tr>
<tr>
<td>- Competitiveness?</td>
<td>Evaluate competitive landscape and relative position</td>
</tr>
<tr>
<td>- Profitability?</td>
<td>Document the record as to choices and rationale</td>
</tr>
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</table>
New Risks & Responses

Risk

- Second guessing by regulators, plaintiffs and courts with related enforcement actions and litigation created by
  - Customer nonpayment
  - Bank regulatory challenges based on unsafe and unsound lending practices and CRA non-compliance
  - CFPB challenges for ATR non-compliance
  - DOJ, bank regulatory, HUD and CFPB Fair Lending challenges
  - Customer complaints and litigation alleging discrimination in the bank’s lending policies and procedures
  - Secondary market put-back, repurchase challenges and collateral haircuts based on type of loan

Response

- Management and board presentations should cover all areas and document a cogent record of choices, risks and costs
- Consult with legal and financial experts
- Conduct legal stress tests to understand risks and make appropriate risk-reducing modifications
- Consider and prioritize risk of challenges and responses
- Retain records as required
Bringing It All Together

- Evaluate compliance and risk management functions to determine capacity to effectively deploy the proposed recommendations.
- Identify the range of legal challenges that can be brought by regulators, private parties, and other governmental authorities based on the mortgage products chosen by the lender (Final Product) and the related legal risks and policies.
- Catalog defenses to claims that may be asserted, and the potential exposures if such defenses are not successful.
- Modify products to strengthen defenses against potential legal challenges and increase secondary market acceptance.
- Have the Board determine the strategic direction based on risk analysis and authorize management to implement its decisions.
- Management and the board should continually monitor implementation of its mortgage lending and servicing strategy.
- Develop a record upon which business decision may be made that regulators can evaluate.
Questions?

- Visit our Financial Resources Reform Site for up-to-date analysis and resources on the Ability-to-Repay and Qualified Mortgage Rules:  [http://www.dechert.com/fs-reform-title-xiv-mortgage-finance-reform/]
For further information, visit our website at dechert.com.

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U.S. Consumer Financial Protection Bureau Seeks Comments to Proposed Amendments to the Ability-to-Repay Requirements and Qualified Mortgage Rule

The U.S. Consumer Financial Protection Bureau (the “Bureau”) has released a proposal (the "Proposal") to amend the Bureau's recently issued final rules (the “Rules”) on the definition of a qualified mortgage (“QM”) and the establishment of ability-to-repay requirements (“ATR”). See our DechertOnPoint, U.S. Consumer Financial Protection Bureau Issues Rules on Qualified Mortgages and Ability to Repay, for a more in depth discussion of the Rules. The Proposal aims to preserve access to credit for certain categories of consumers who may otherwise be adversely affected by the Rules. The Bureau is seeking public comments on the Proposal, which must be received by February 25, 2013. A discussion of the key aspects of the Proposal follows.

Exemption from the ATR Requirement

The Bureau proposes to exempt from the ATR requirements loans made or administered by, or related to:

- a program administered by a housing finance agency;
- certain types of non-profit creditors, including: (i) those designated by the Department of Housing and Urban Development as either a Community Housing Development Organization or a Downpayment Assistance Provider of Secondary Financing; and (ii) those designated under 501(c)(3) of the Internal Revenue Code, subject to certain restrictions;
- an Emergency Economic Stabilization Act program, such as a State Hardest Hit Fund program;
- a refinancing that is eligible to be insured, guaranteed or made pursuant to a program administered by the Federal Housing Administration, the Department of Veterans Affairs, or the Department of Agriculture, until that federal agency prescribes its own ATR refinance rules; and
- a refinancing that is eligible to be purchased or guaranteed by Fannie Mae or Freddie Mac, so long as it is made: (i) pursuant to an eligible targeting refinancing program; (ii) such entities are operating under conservatorship on the date the refinancing is consummated; (iii) the existing obligation satisfied and replaced is owned by Fannie Mae or Freddie Mac; (iv) the existing obligation satisfied and replaced was not consummated on or after January 10, 2014; and (v) the refinancing is not consummated on or after January 10, 2014.

The Bureau explained the need for these exemptions from the ATR requirement in a number of ways. Principally, the Bureau does not want access to credit to be overly restricted for the populations targeted by the Proposal. The Bureau felt that the specified organizations benefit the community as a whole. Additionally, the Bureau found that the programs offered by these entities have complex and comprehensive underwriting requirements, are already subject to significant government monitoring and will still ensure that consumers have a general ability to repay without requiring them to comply with the ATR requirements. Additionally, with respect to programs aimed at preventing foreclosure and other housing-stabilization initiatives, the Bureau cited the need to continue to help consumers and communities recover from the aftermath of the financial crisis. The Bureau also stated that many of the organizations that administer these programs are small and lack the resources and flexibility to implement the ATR requirements.
Creation of an Additional Class of QM

The Bureau cited a number of factors for adding another category of loans that are eligible for QM status. This category would consist of certain loans made by a small creditor that (a) had total assets of $2 billion or less at the end of the previous calendar year, and (b) which together with all affiliates, originated 500 or fewer first-lien covered transactions during the previous calendar year ("Small Creditor"). These loans would have to comply with all of the requirements under the general definition of a QM except the 43% limit on the monthly debt-to-income ratio, although the Small Creditor would still have to consider and verify the consumer’s income and assets and consider the consumer’s debt-to-income ratio and residual income. A loan would lose its status as a QM if it is held in portfolio for less than three years after consummation, with certain exceptions, including if it is transferred to another Small Creditor, if it is transferred pursuant to a supervisory action or by a conservator, receiver or bankruptcy trustee, or if it is transferred as part of a merger or acquisition of the creditor.

The Bureau explained the need for this additional class of QM in a number of ways. It noted that many Small Creditors have stated that they will be unwilling to make loans under the QM and ATR Rules. The Bureau recognized that Small Creditors often fill a niche by considering loans to consumers or properties that do not conform to standardized underwriting criteria used by larger creditors, and that such loans may be viewed as illiquid by larger lenders and therefore entail greater risk. While larger creditors may be unwilling to make such loans, the Bureau noted that Small Creditors are often willing to evaluate the merits of unique consumers and properties, using flexible underwriting criteria to make highly individualized underwriting decisions. Small Creditors would also hold these loans on their balance sheets, retaining the associated credit, liquidity and other risks, thus creating an additional incentive to responsibly underwrite these loans.

The Bureau also stated that Small Creditors are a significant source of credit in rural areas and are more likely to lend on a “relationship basis,” and must engage in responsible underwriting to preserve their reputations in their communities. The Bureau commented that Small Creditors as a group have consistently experienced lower credit losses for residential mortgage loans than larger creditors, which the Bureau interpreted as evidence of historically responsible lending practices. It is interesting to note that the Bureau, in the ATR rule, stressed the need for consistent application of an institution’s underwriting policies. However, in the Proposal, the Bureau takes a different approach. The Bureau suggested that underwriting based on “qualitative information, often referred to as ‘soft’ information, that focuses on subjective factors such as consumer character and reliability, which ‘may be difficult to verify, and communicate through the normal transmission channels of a banking organization’ may have contributed to Small Creditors’ historically responsible lending practices.

Changes to the Safe Harbor v. Rebuttable Presumption Threshold

As part of the new type of QM that would be available to Small Creditors, the Bureau has proposed to raise the annual percentage rate these creditors could charge and still benefit from a safe harbor. The Bureau has proposed to make the same change applicable to Small Creditors serving predominantly in rural or underserved areas who offer first-lien balloon loans that will be held in portfolio ("Small Rural Creditors").

Under the Rules, a QM safe harbor is given to first-lien qualified mortgages with an annual percentage rate less than or equal to the average prime offer rate plus 1.5 percentage points (3.5 percentage points for subordinate-lien loans). Under the proposed rules, Small Creditors and Small Rural Creditors would qualify for the safe harbor as long as the annual percentage rate is less than or equal to the average prime offer rate plus 3.5 percentage points for both first-lien and subordinate-lien loans.

The Bureau explained the need for a higher threshold rate on the grounds that Small Creditors and Small Rural Creditors may charge consumers higher interest rates and fees than larger creditors for several legitimate business reasons. According to the Bureau, these creditors may pay more for funds than larger creditors. Small Creditors and Small Rural Creditors generally rely heavily on deposits to fund their lending activities and therefore pay more in expenses per dollar of revenue as interest rates fall and the spread between loan yields and deposit costs narrows. The Bureau stated that Small Creditors and Small Rural
Creditors may also rely more on interest income than larger creditors, as they often do not receive as much additional income from non-interest sources such as trading, investment banking or fiduciary services. The Bureau also raised the concern that Small Creditors and Small Rural Creditors need to charge higher rates to compensate for their exposure to interest rate risk, credit risk, and liquidity risk. Finally, the Bureau noted that these types of creditors may be particularly burdened by the time, effort and cost of ATR litigation and that it may be particularly difficult for small creditors to absorb the cost of adverse judgments.

Footnotes


2. Proposal, p. 46.
U.S. Consumer Financial Protection Bureau Issues Rules on Qualified Mortgages and Ability to Repay

Congress in the Dodd-Frank Act responded to concerns about the quality of mortgage loans by establishing incentives for lenders to seek to ensure that borrowers had the ability to repay mortgage loans made to them. In response to a directive from Congress, the Consumer Financial Protection Bureau (the “Bureau”) has issued its much anticipated Ability-to-Repay (“ATR”) Rule and Qualified Mortgage (“QM”) Rule (the “Rules”), which will go into effect on January 14, 2014. The following is a brief overview of the new Rules.

The Ability-to-Repay Rule

The key to the Rules is the ATR requirement, which will require a lender to make a reasonable and good faith determination that a consumer has a reasonable ability to repay a loan in accordance with its terms. Any lender that fails to satisfy the ATR rule will be at risk for the following penalties and liabilities:

1. general Truth in Lending Act damages,
2. special ATR statutory damages, and
3. in a foreclosure action, a defense by recoupment or setoff.

The Structure of the New Ability-to-Repay World

Under the structure provided by the Bureau’s Rules, there will be three categories of loans.

QM Safe Harbor Loans. The first category will be those QMs that qualify for a safe harbor from the penalties and liabilities described above. These are first lien loans on a covered consumer credit transaction secured by a dwelling (a “Covered Transaction”) which have an interest rate of less than 1.5% (or 3.5% for subordinate lien loans) higher than the average prime offer rate available in the vicinity (“Prime Loans”) and which meet the QM requirements. Such loans would be subject to a safe harbor and deemed to comply with the ATR requirements.

QM Rebuttable Presumption Loans. The second category will be those QMs that qualify for a rebuttable presumption of compliance as protection from the same penalties and liabilities described above. These are first lien loans on a Covered Transaction, which have an interest rate equal or greater than 1.5% (or 3.5% for subordinate lien loans) above the average prime offer rate available in the vicinity (“Higher-Priced Loans”) and which meet the QM requirements. Such loans would be subject to a rebuttable presumption that the lender satisfied the ATR requirements.
**Non-QM Loans.** The final category will be all Covered Transactions that are not QMs. These loans must comply with the ATR requirements. The Rules do not create legal protections for lenders in regards to this category of loans.

**The Legal Difference Between a Safe Harbor and a Rebuttable Presumption**

When a loan qualifies for the safe harbor, if the lender is sued by a borrower for failure to comply with the applicable requirements, as long as the lender can successfully show that the loan is a QM, the lender would be subject to a safe harbor and deemed to comply with the ATR requirements.

If a loan only qualifies for a rebuttable presumption, the borrower would be able to present evidence to challenge the lender's determination that the borrower satisfied the ATR requirement at the time of origination.

Specifically, to overcome the rebuttable presumption, a borrower must prove that, despite meeting the QM requirements, the lender did not make a reasonable and good faith determination of the borrower's ability to repay at the time of consummation, by showing that the borrower's income, debt obligations, alimony, child support and the borrower's monthly payment (including mortgage-related obligations) on the loan and on any simultaneous loans of which the lender was aware would leave the borrower with insufficient residual income or assets other than the value of the dwelling (including any real property attached to the dwelling) that secures the loan with which to meet living expenses, including any recurring and material non-debt obligations of which the lender was aware at the time of consummation.

The Bureau did not define living expenses or recurring and material non-debt obligations, but wrote in its commentary that these might include costs such as food, clothing, gasoline and health care, including the payment of recurring medical expenses. The lack of clear definitions may mean that lenders will want to conduct expanded diligence on a borrower's personal monthly expenses as part of their ATR processes.

**A Qualified Mortgage**

To meet the definition of a QM, a loan must not contain certain features, including:

1. excessive upfront points and fees (those exceeding 3% of the total loan amount, less “bona fide discount points” for prime loans),
2. interest-only payments,
3. negative-amortization, and
4. terms of longer than 30 years.

Additionally, in order to qualify as a QM, a loan must be made to a borrower whose total monthly debt-to-income ratio does not exceed 43%. To qualify as a QM, lenders must also verify and document the income and financial resources relied upon to qualify the borrower on the loan and underwrite the loan based on a fully amortizing payment schedule and maximum interest rate during the first five years, taking into account all applicable taxes, insurance and assessments.
Application of QM Rule to GSE-Eligible Loans

To ease the effect of this new rule and encourage the continued recovery of the mortgage market, loans that do not meet the 43% debt-to-income ratio, but that do meet other government-related loan standards, including loans which are eligible to be purchased by Fannie Mae and Freddie Mac (provided that they remain in conservatorship), the Department of Housing and Urban Development, the Department of Veterans Affairs, the Department of Agriculture or the Rural Housing Service will also be considered QMs. This temporary provision will phase out over time as the various agencies issue their own QM rules and if GSE conservatorship ends, and in any event after 7 years (ending January 10, 2021). Just as is the case with QMs that meet the standard requirements of the QM Rule, these loans will either provide lenders with a safe harbor or a rebuttable presumption based on whether they are Prime Loans or Higher-Priced Loans.

Ability to Repay Standards

In order to meet the ATR requirements, a lender must consider and verify eight underwriting standards for the borrower, consisting of:

1. current or reasonably expected income or assets,
2. current employment status,
3. the monthly payment on the covered transaction,
4. the monthly payment on any simultaneous loan,
5. the monthly payment for mortgage-related obligations (such as property taxes),
6. current debt obligations, alimony and child support,
7. the monthly debt-to-income ratio or residual income, and
8. credit history.

The Practical Impact on the Market

Although the QM definition includes a broad spectrum of loans, there will likely be a significant preference among lenders and loan purchasers for QM loans which qualify for the safe harbor.

Lenders may be reluctant to make QMs that will only provide a rebuttable presumption or non-QM loans. As a result, there could be contraction and realignment in the mortgage market for non-prime borrowers. This may disproportionately affect low-income populations and certain geographic areas, raising questions as to whether government regulations are incentivizing lending standards that have a disparate impact, which, in turn, may generate fair lending challenges by the government and private parties and performance evaluation issues under the Community Reinvestment Act.

Another potential impact may be seen in the ability to securitize loans. Safe harbor QMs will be more predictable and thus may be more easily securitized. Securitization may be more complicated for QMs with
a rebuttable presumption, as the resulting loans will be less homogeneous, the loans will be more likely to face legal challenges for the first few years, and the market may have less appetite for the product.

The Bureau estimates that based on 2011 data (without temporary government-related purchase QM treatment) 76% of mortgages would have been QM safe harbor loans, 2% of mortgages would have been QM rebuttable presumption loans and 22% of mortgages would have been non-QM loans. Taking account of, among other things, existing regulations regarding Higher-Priced Loans, the Bureau states that in the current marketplace, it anticipates that the impact of the Rules on access to credit will be very small. The Bureau further observes that to the extent that the Rules reduce credit access, the Rules will primarily reduce lending that ignores or inappropriately discounts a consumer’s ability to repay a loan, rather than impeding access to credit for borrowers who have the ability to repay.

Additional Proposed QM Rule

The Bureau has also released a proposal to amend the Rules to provide QM status to certain loans made and held in portfolio by small creditors, and to exempt certain nonprofit creditors and certain homeownership stabilization programs from the requirements contained in the Rules. The comment period on this proposal is open through February 25, 2013.

Dechert LLP to Host QM Rule Webinar

Dechert will host a live webinar on Wednesday, January 23 from 12:00 - 1:00 PM Eastern focusing on the legal and practical impacts these important developments will have on lenders, borrowers, loan purchasers and securitizers.

To register for this webinar, “A New World for Mortgage Lending: CFPB Issues Qualified Mortgage Rule.” visit https://dechertevents.webex.com/dechertevents/onstage/g.php?t=a&d=665281892

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See our Dodd-Frank reference materials for up to date analysis and regulatory actions at http://www.dechert.com/fs-reform/.

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A Strategic Guide to the ATR/QM Rules

Managing the Regulatory Options, Risk Exposures and Legal Responsibilities for the New Ability-to-Repay and Qualified Mortgage Rules

June 2013
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Introduction

The Dodd-Frank Act (“DFA”) and its implementing regulations promulgated by the Consumer Financial Protection Bureau (“Bureau”) will significantly impact the way that the residential mortgage and corresponding secondary markets function in the U.S. In turn, the implementation of these changes will trigger significant corporate governance questions, including the best way to integrate the board of directors into the process. In January 2013, the Bureau issued rules to mandate lender “ability-to-repay” requirements (“ATR”) to address concerns that residential mortgage borrowers received loans that they were not adequately positioned to repay. These rules, which will become effective on January 10, 2014, create legal advantages for lenders if those loans are treated as qualified mortgages (“QMs”). Given the complete reshaping of the relationship between mortgage borrowers and lenders compelled by these new rules, there is much work to be done before banks can begin to implement them.

Unlike many prior federal actions in this area, the Bureau’s rules implementing the ATR requirement and the QM provisions (together the “ATR Rules”) do not merely impact disclosures or timing; they create a fundamentally new paradigm for banks involved in residential mortgage lending by creating three categories of loans with very different legal treatments and risk implications:

- Non-QM Loans
- QM Safe Harbor Loans
- QM Rebuttable Presumption Loans

These new rules present management and directors with a range of new challenges and opportunities that each bank will have to evaluate. Management and directors will have to consider the corresponding profit, risk and legal implications of the different business options that are available in order to discharge their duties as overseers of the business of the bank.

We recognize that one size does not fit all in regard to bank responses to the ATR Rules. Each bank has its own unique corporate governance culture. Management and boards of directors may take a wide range of approaches in working together to pursue the best interests of their institutions. Unique circumstances may result in very different responses to the ATR Rules. In that regard, nothing in this Guide is intended to suggest that any institution is expected or required to follow a particular corporate governance approach or business strategy in response to the ATR Rules. This document is merely intended to provide bankers with guidance they may wish to consider in response to the ATR Rules.

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Executive Summary

As the ATR Rules currently stand, banks that engage in residential mortgage lending will have to be prepared to operate in compliance with the rules on January 10, 2014. Unless this effective date is extended, there will be significant time pressure to develop and implement strategic responses to the ATR Rules.

Under the ATR Rules, lower priced loans that meet regulatory requirements specified for QM Safe Harbor Loans will be protected from damage claims and defenses by borrowers based on a failure to meet ATR requirements. Higher priced QM Rebuttable Presumption Loans that meet the QM requirements will receive a lesser degree of protection from damage claims and defenses by borrowers. Finally, non-QM Loans will not receive any protection for borrower ATR damage claims or defenses.

Under the ATR Rules, QM Loans must fit within a template based on loan terms, a maximum level of points and fees and a 43% maximum debt-to-income ratio. There will be a temporary exception for loans that would be eligible for participation in certain government or government sponsored enterprises residential mortgage programs. QM Loan treatment will also be available under certain circumstances for loans made by small creditors. In contrast, non-QM Loans are generally not subject to regulatorily specified underwriting requirements and lenders are generally free to design their own underwriting standards provided that they satisfy the ATR requirement.

Each bank will have to consider which of the three types of residential mortgage loans it will make as of the effective date of the ATR Rules. Different institutions may have very different perspectives on this core issue. Some institutions may wish to restrict their lending, at least initially, to QM Safe Harbor Loans in order to seek to limit their potential exposure to borrower claims and defenses, reevaluating that decision once a track record develops as to how local courts will handle borrower ATR Rules claims and defenses. Some institutions may be reluctant to make loans other than QM Safe Harbor Loans because of concerns that such loans be difficult to sell or may have limited value as collateral.

Other institutions may be confident that they will be able to defend their ATR decisions on non-QM Loans against borrower challenges. Some institutions may decide that making non-QM Loans is a critical and necessary element of their mortgage lending strategy. Other institutions may be concerned that a decision to not make non-QM Loans could adversely impact the institution’s Community Reinvestment Act rating or may result in governmental or private party fair lending investigations or suits.

For each bank there will be a series of regulatory, legal, business and operational issues that will have to be identified and evaluated. In some instances, the answers to these issues may not be clear at the time the bank has to select a path to follow in order to achieve compliance by January 10, 2014.

Management will have to synthesize the options available to a bank and the respective pros and cons of those options and develop a recommendation for the bank’s board of directors to consider. The board, in consultation with management, will ultimately arrive at a path for the bank to take in implementing the ATR Rules, taking account of the special circumstances that apply to the bank. Management will then have to take the full range of actions necessary to implement the bank’s strategy and ensure that adequate operational and risk management controls are in place.

As banks go through the ATR Rules implementation process it will be important for them to closely monitor regulatory developments, as well as industry and market responses, and be prepared to make changes to their implementation strategy as necessary.
Legal Framework for ATR Rules Implementation

The implementation of the ATR Rules will implicate a series of legal standards and requirements. A bank will want to consider these principles and requirements as it develops its ATR strategy.

1. **Fiduciary Duties**

Directors and officers of a bank are subject to fiduciary duties in regard to their exercise of their official responsibilities. These duties are generally described as a duty of care and a duty of loyalty. Bank regulators have also established their own expectations for directors and officers of banks, which include operating the bank in compliance with applicable laws and regulations and not causing the bank to engage in unsafe and unsound conduct. In these regards, directors and officers whose conduct does not satisfy applicable standards may be subject to a range of administrative enforcement actions initiated by regulators, which may impose varying degrees of sanctions and penalties.

2. **Specific Legal Requirements with Regard to Application of the ATR Rules**

2.1. **Developing and Deciding on the Bank’s ATR Rules Implementation Strategy**

The decisions that management and directors make about selecting strategic directions for the future mortgage activities of their bank and ensuring that the bank has designed appropriate policies and compliance procedures will be viewed after the fact through the lens of the duty of care. Thus, the corporate record that the bank creates as these decisions are made is quite important.

To make decisions consistent with the oversight responsibilities of a board of directors, the board does not need to focus on each of the nuts and bolts of the new ATR Rules. It should, however, understand the parameters and important implications of the new ATR Rules and how they will impact the operations and legal and risk exposure of the bank and its directors and officers. A bank’s management will analyze the full range of issues related to the bank’s market position and mortgage operations and develop a presentation to the board that will likely include an explanation of each of the ATR Rules implementation options that may be available to the bank. Management will likely provide its views of the pros and cons of each of the alternatives and make a recommendation to the board as to the approach that management recommends the board approve.

2 Under the business judgment rule, where the directors of a bank acted on an informed basis, in good faith and in the belief that the action taken was in the best interests of the bank they are entitled to a defense against liability, even where the impact of their decision injures the bank. In that case, a court will not substitute its judgment for that of the board, unless it is shown by a preponderance of the evidence that the directors’ decision involved a breach of fiduciary duty. That places a premium on good corporate governance and the development of a solid record upon which the board makes its decisions.

3 12 U.S.C. §1818(b), (c), (e), (i). Directors and officers can be subject to cease and desist orders, civil money penalties and removal and prohibition based on, among other things, violations of laws or regulations, engaging in unsafe and unsound practices or breaches of fiduciary duty. See OCC Policies & Procedures Manual, Enforcement Action Policy (Sept. 9, 2011).
The record for board decisions should encompass the factors discussed below.

### The Importance of the Record

Directors should have a record that demonstrates that they were fully informed about the choices available to their bank, critically analyzed the pros and cons of the available options, and acted prudently. They should have received a comprehensive presentation that they can reasonably rely on from management and outside financial and legal experts, as appropriate. The record should clearly reflect that the board understood and carefully considered the relevant aspects of the course that they choose for the bank and have determined that it is an appropriate approach for the bank to take. By taking such an approach, the directors will enhance the likelihood that the direction chosen for the bank is sound and that they will have the benefit of the business judgment rule if their compliance with their fiduciary duties is put at issue.

### 2.2. Real Estate Lending Standards

Actions taken by a bank in connection with implementing the ATR Rules will be subject to the real estate lending standards that have been adopted by the federal banking agencies (“Lending Standards”). They require a bank to adopt written real estate lending policies to monitor compliance with those policies with regard to (i) loan portfolio diversification, (ii) prudent underwriting standards, (iii) loan administration procedures, and (iv) documentation, approval, and reporting requirements.

A bank’s policies under the Lending Standards rule must also address the detailed guidance provided by the interagency guidelines related to the Lending Standards. The bank’s policies must be reviewed and approved by the bank’s board of directors at least annually.

A bank’s implementation of its strategic approach to the ATR Rules will likely involve significant revisions to its real estate lending policies, and the board of directors should be fully advised and be satisfied with those changes.

### 2.3. Safety and Soundness Standards for Real Estate Lending

Banks are subject to safety and soundness standards adopted by the federal banking agencies. These include standards regarding credit underwriting practices and residential mortgage lending practices. These standards will have to be carefully integrated into a bank’s policies as it develops its business model in response to the ATR Rules. A bank that does not meet safety and soundness standards and fails to implement an acceptable remediation plan may be subject to enforcement action.

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4 12 C.F.R. § 34.62 (OCC); 12 C.F.R. § 208.51 (Federal Reserve Board “FRB”); 12 C.F.R. § 365.2 (FDIC).

2.4. Community Reinvestment Act

A bank should understand and evaluate how various options for complying with the ATR Rules could impact the bank’s Community Reinvestment Act (“CRA”) performance, particularly under the lending test. Poor CRA ratings can have an adverse impact on the bank in a variety of contexts, so banks must carefully weigh this consideration as part of developing their bank’s ATR Rules compliance plans.

2.5. Fair Lending Considerations

Another important concern is a bank’s compliance with the fair lending laws. Since QM Loans naturally will create tighter underwriting standards that may narrow the range of qualified borrowers, how a bank approaches compliance with the ATR Rules could have an adverse impact on the bank’s ability to respond to a governmental fair lending inquiry, or to a private party claim under the fair lending laws, i.e., the Equal Credit Opportunity Act and the Fair Housing Act. Banks will also want to take account of this consideration as they develop their ATR Rules compliance plans.

2.6. Violations of Laws and Regulations and Unsafe and Unsound Practices

A bank is subject to enforcement action if it violates laws or regulations or engages in unsafe and unsound practices. As discussed below, banks that make non-QM Loans may be subject to claims that certain loans do not meet the ATR requirement and, thus, violate the Truth in Lending Act and the Bureau’s ATR Rules. These claims may be made by borrowers as well as regulators. Widespread claims of this type could potentially be viewed as constituting an unsafe and unsound practice. In addition, to the extent that banks lend beyond the limits of a QM Loan, any weakness in the portfolio of the bank may be attributed to unsafe and unsound lending practices. These and other issues related to the ATR Rules could form the basis for an enforcement action against a bank. Banks may also be concerned that examiners will focus special scrutiny on non-QM Loans for potential consumer law compliance issues.

ATR Rules, Fair Lending and Safety & Soundness

Management and members of a bank's board of directors could be subject to enforcement actions by bank regulators with respect to alleged violations of laws or rules by their bank, or for alleged unsafe or unsound practices. Such actions may include cease and desist orders, civil money penalties and removal and prohibition from the banking industry. Board members should be in a position to demonstrate that the bank, management and board itself carefully analyzed the ATR Rules and that bank's options for complying with the Rules. Board members will also want to make sure that the bank puts in place a set of policies and procedures that are reasonably designed to result in compliance with the ATR Rules. The board’s ability to demonstrate that it took a careful, considered and comprehensive approach, taking full advantage of the expertise and knowledge of management and outside experts will be very important in the event that a bank comes under enforcement review in regard to its ATR Rules compliance.
2.7. The Challenges Create Opportunities

While the ATR Rules will pose significant challenges for management and boards of banks which already are highly regulated, this new environment will also present opportunities for individual institutions to enhance their competitive advantage in the marketplace. In short, to the extent that a bank does not wisely choose among the risk/reward ratios, and ends up confronting significant costs and legal liabilities, it will be at a disadvantage with its competitors.
The Requirements of the ATR Rules

Of the numerous residential mortgage-related rules that the Bureau has issued, the ATR Rules will by far have the most significant strategic implications. Boards will have to understand the implications of this and other recently issued Bureau rules applicable to residential mortgage lending operations, including rules regarding mortgage servicing and loan originator compensation.6

1. The ATR Requirement for Non-QM Loans

The ATR Rules establish a suitability standard for residential mortgage loans.7

_Lenders are prohibited from making a covered residential mortgage loan unless the lender makes a reasonable and good faith determination that the consumer will have a reasonable ability to pay the loan according to its terms (“ATR Requirement”)._

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**The ATR Requirement**

The ATR Requirement mandates that a lender consider eight factors in determining a consumer’s ATR:

- current or reasonably expected income or assets;
- employment status, if the creditor is relying on employment for repayment;
- monthly payment on covered loan;
- monthly payment on a simultaneous loan secured by the same property;
- monthly payment for mortgage-related obligations;
- current debt obligations, alimony and child support;
- monthly debt-to-income ratio (“DTI”) or residual income; and
- credit history.

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7 The ATR Rules apply to “covered transactions” as defined in 12 C.F.R. § 1026.43(a).
As a consequence of this ATR Requirement, foreclosing on a delinquent borrower will likely become significantly more difficult because counsel for many delinquent borrowers will attempt to put the lender on trial, by arguing that the borrower is delinquent on the loan because the lender made a loan that it should have known the borrower would not be able to repay. A borrower who is able to mount a strong challenge in this regard may effectively be able to prevent a foreclosure or negotiate more favorable loan terms. Banks will also have to consider the extent to which the new Mortgage Servicing Rules will add significant additional time and expense to the foreclosure process.

*In short, banks should fully appreciate the defenses that will be raised and the challenges that will be leveled by borrowers so that they can bullet-proof their programs, policies and procedures as much as possible.*

1.1. **Specific Underwriting Standards Are Generally Not Imposed Under the ATR Requirement**

Although a creditor is required to consider the eight factors described above, the ATR Requirement does not mandate any specific underwriting standards for a creditor. Thus, unlike with QM Loans, there is no maximum DTI ratio. Lenders are generally both free and legally responsible for developing underwriting standards that address their own unique experiences and circumstances. In this regard, the Bureau has expressly recognized that in many instances, appropriate, prudent loans will not meet the QM requirements in the ATR Rules, and the Bureau encourages creditors to make non-QM loans. But lenders should understand the risks that attend making non-QM loans and the policies and robust controls that they will need to do so.

1.2. **Risks and Costs**

The ATR Rules that apply to non-QM Loans, unlike the treatment of QM Loans, do not provide any extraordinary legal defenses to lenders who are subject to an ATR challenge by a borrower. Whether an ATR determination is reasonable and in good faith will depend not only on the creditor’s underwriting standards, but on the facts and circumstances of a particular loan and how the creditor’s standards were applied to those facts and circumstances. This provides a borrower the opportunity to argue that a creditor’s underwriting standards were too lax and that the creditor failed to appropriately apply its standards to the specific circumstances of the borrower. It also puts a burden on the lender to demonstrate the appropriateness of its policies and the strength of its controls.
Also of significance to the bank should be the financial penalties that attend non-compliance with the ATR Rules. The range of potential damages and penalties are described below.

### 1.3. The Bureau’s Guidance Regarding Compliance with the ATR Requirements

The Bureau provides guidance as to factors that might be considered in determining whether a lender properly made an ATR determination. Unfortunately, these factors may encourage borrowers’ counsel to seek extensive discovery regarding the development and operational effectiveness of a lender’s underwriting standards. They will also raise issues where there is an inconsistent application of underwriting standards that may be viewed as allowing an unqualified borrower to obtain a loan.

Since the Bureau did not adopt any fully determinative guidance regarding the adequacy of an ATR determination, this issue will ultimately be determined in court proceedings relating to individual loans. In those cases, the court will have to determine the nature and extent of discovery that it will permit, and then make individual substantive decisions as to whether the ATR requirement was satisfied in a particular case. Over time, it can be expected that courts will develop standards for both of these issues and lenders will need to adjust accordingly.

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8 ATR Rules, Supplement I to Part 1026—Official Interpretations, Section 1026.43(c)(1). The Bureau states that the following factors may be evidence that an ATR determination was reasonable and in good faith: (i) the consumer demonstrated actual ability to repay by making timely payments for a significant period after consummation, (ii) the creditor used underwriting standards that have historically resulted in comparatively low rates of default during adverse economic conditions, or (iii) the creditor used underwriting standards based on empirically derived, demonstrably and statistically sound models. The Bureau also states that the following factors, among others, may be evidence that an ATR determination was not reasonable or in good faith: (i) the consumer defaulted on the loan a short time after consummation, (ii) the creditor used underwriting standards that have historically resulted in comparatively high levels of default during adverse economic conditions, (iii) the creditor applied underwriting standards inconsistently, (iv) the creditor disregarded evidence that its underwriting standards are not effective at determining repayment ability, or (v) the creditor disregarded evidence that the consumer would have insufficient residual income to cover recurring obligations and expenses after taking into account mortgage obligations and current debt obligations.
In near term, lenders will face a significant level of uncertainty when they are presented with borrower ATR claims. They are essentially on their own when it comes to implementing the rules and adopting policies and controls. That creates a significant responsibility on banks, their managements and boards of directors.

1.4. Liability for an ATR Requirement Violation

A lender that is found to have not complied with the ATR requirement is subject to general Truth in Lending Act damages and special ATR statutory damages that may be up to the sum of all finance charges and fees paid by the consumer. Furthermore, when a lender or an assignee initiates a foreclosure action, a consumer may assert an ATR violation as a basis for recoupment or setoff. Thus, from a practical perspective, an undeniably delinquent borrower may be able to prevent a foreclosure. Borrower’s counsel, in many instances, may use the prospect of an ATR challenge to seek to arrive at a resolution with a creditor that leaves the borrower in possession of the property on new loan terms. In short, in the case of a proven violation, it is possible that the lender may find it more advantageous to actually forgive a significant portion of the remaining indebtedness, thereby raising issues as to the value of a portfolio of loans that may bear the same defects.

1.5. Presenting This Information, the Options and Risks to the Board of Directors

In light of the foregoing, to the extent that a bank is considering making non-QM Loans, management and its advisors should present directors with information and strategic choices that address:

- the proposed underwriting standards that the bank would use to make non-QM Loans;
- the policies and procedures that the bank would use to implement the underwriting standards with respect to individual loan applications;
- the expected credit quality implications of the proposed underwriting standards;
- the market and competitive implications of making non-QM Loans;
- the vendor and other requirements and controls necessary to put a non-QM Loan program in place and the expected timing;
- the costs and potential profit related to making non-QM Loans;
- the legal and practical risks associated with non-QM Loans;
- the potential for non-QM Loans to be sold, securitized or used as collateral;
- the implications of making non-QM Loans for CRA rating purposes;
- the implications of making non-QM Loans for purposes of fair lending compliance;
- the costs of litigating ATR challenges; and
- an overall analysis of the risks and rewards of making non-QM Loans and a recommendation from management as to which course for the bank to take.
2. QM Loans

The ATR Rules purport to provide lenders a way to avoid certain risks for mortgage loans treated as QMs, but the defenses vary based on whether the mortgage is a lower-priced QM Loan (“QM Safe Harbor Loan”) or a higher-priced QM Loan (“QM Rebuttable Presumption Loan”).

### General Characteristics of a QM Loan

- Regular periodic payments that are substantially equal, subject to interest rate adjustments
- No negative amortization
- No deferral of principal
- No balloon payments
- Points and fees may not be excessive (those exceeding 3% of the total loan amount on a loan exceeding $100,000)
- Term cannot exceed 30 years
- Underwritten based on the maximum interest rate during the first five years
- Based on verified current or reasonable expected income or assets and current debt obligations, alimony and child support
- Monthly debt to income (“DTI”) ratio may not exceed 43%

#### 2.1. The QM Safe Harbor

If a loan meets the QM requirements, and is a first lien loan which has an interest rate that does not exceed the average prime offer rate (“APOR”)\(^9\) for comparable transactions by 1.5% or more (or 3.5% or more for subordinate lien loans), it is a QM Safe Harbor Loan. The benefit of such treatment is that if the loan is challenged by a defaulting borrower, for example, it will be deemed to comply with the ATR requirements for purposes of the ATR Rules. This creates an incentive for lenders to make QM Safe Harbor Loans. The degree of the incentive will, however, be a function of the legal protections that are actually available.

As a practical matter, the lines of demarcation are not likely to be so bright. A borrower may seek to challenge a loan’s QM status by, among other things, asserting that the loan exceeded the cap on points and fees, or that the loan’s DTI ratio exceeded 43%. The Bureau does not address what would happen if a borrower successfully challenged a loan’s QM Safe Harbor status. Presumably, the borrower’s counsel would argue that the lender would have to demonstrate that the loan satisfied the ATR requirement. If such an argument were accepted by a court, a lender’s inability to show that a proper ATR determination was made at the time the loan was made would leave the lender potentially subject to the penalties and defenses available where an ATR requirement on a non-QM Loan was not satisfied.

\(^9\) The average prime offer rate is defined in 12 C.F.R. § 1026.35(a)(2).
2.2. The QM Rebuttable Presumption

If a loan meets the QM requirements and it is a first lien loan which has an interest rate that exceeds the APOR for comparable transactions by 1.5% or more (or 3.5% or more for subordinate lien loans), it will be treated as a QM Rebuttable Presumption Loan. Unlike a QM Safe Harbor Loan, a QM Rebuttable Presumption Loan will not be deemed to comply with the ATR requirements. Instead, such a loan will merely have the benefit of a presumption that it satisfies the ATR requirements.

Thus, even if a borrower is unable to demonstrate that a QM Rebuttable Presumption Loan did not meet the QM requirements, the borrower could nevertheless challenge the loan under the following formulation established by the Bureau under which the borrower would have to prove that the lender did not make a reasonable and good faith determination of the consumer’s ATR at the time of the consummation of the loan. The borrower would establish its burden of proof by demonstrating that the consumer’s income, debt obligations, alimony, child support, the monthly payments on the covered transaction, and any simultaneous loan of which the lender was aware at consummation, would leave the consumer with insufficient residual income or assets to meet living expenses (including recurring non-debt obligations known by the creditor at time of consummation).

Presumably, a borrower that successfully made such a challenge to a QM Rebuttable Presumption Loan would argue that the ATR requirement was not satisfied, and thus, the borrower was eligible for ATR damages and defenses.

The Value of the QM Protections

There are yet to be resolved questions as to the practical value of the safe harbor and rebuttable presumptions that accompany QM Loans. From a lender’s perspective, it would be desirable that if certain underwriting or loan factors can be checked off, the lender could be protected from liability for making a loan that was not suitable for the borrower. Thus, for QM Safe Harbor Loans, the assumption is that they should not be able to be challenged and that the cost of litigation should be minimal. However, in the real world, plaintiffs’ lawyers are likely to throw a litany of charges at the lender and assert that the loan is not a QM Safe Harbor Loan. In those circumstances, the lender has to offer evidentiary proof about the QM nature of the loan, which may be challenged. Therefore, it is not yet clear how much protection has been gained, except to know that once the lender prevails in that evidentiary process, it enjoys the protection from the liabilities and defenses that attach to making a non-ATR compliant loan. Until these types of issues work themselves through, there will be questions regarding the value of the QM protections. In the case of a QM Rebuttable Presumption Loan, a lender, in addition to facing a potential challenge to the QM status of the loan, will have to be able to demonstrate that it satisfies the special requirements for such loans.
2.3. Temporary QM Treatment for Government and GSE-Eligible Loans

In an effort to smooth the transition to the ATR Rules, the Bureau provided that a mortgage loan eligible to be purchased, guaranteed, or insured (as applicable) by certain government entities—the Department of Housing and Urban Development, the Department of Veterans Affairs, the Department of Agriculture and the Rural Housing Service, or by Fannie Mae or Freddie Mac (as long as they remain in conservatorship)—will be treated as a QM Loan as long as it meets the following requirements:

- regular periodic payments that are substantially equal, subject to interest rate adjustments.
- no negative amortization.
- no deferral of principal.
- no balloon payments.
- no excessive points and fees (those exceeding 3% of the total loan amount on a loan exceeding $100,000).
- term does not exceed 30 years.

*These loans (“Government Related Loans”) do not have to meet the 43% maximum DTI ratio that is otherwise applicable to QM Loans.*

### The Benefits of a Government Related Loan

In order to qualify for Government Related Loan status, a loan would not actually have to be purchased, guaranteed or insured. It would only have to be eligible for such a transaction. If a loan qualifies as a Government Related Loan, its status as a QM Safe Harbor Loan or QM Rebuttable Presumption Loan depends on the pricing of the loan. This treatment of Government Related Loans ends when the GSEs end their receivership status, or in January 2021. The Bureau expects that the impact of the Government Related Loan exception will be to allow loans that would otherwise be non-QM loans to be able to take advantage of QM status.

2.4. Small Creditor Loans QM Treatment

In May 2013, the Bureau amended the ATR Rules to create a special category of QM Loans (“Small Creditor QM Loans”) that may be made by lenders that qualify as “Small Creditors.” A Small Creditor is a creditor that had total assets of $2 billion or less at the end of the prior calendar year, and together with all affiliates originated 500 or fewer covered transactions.

In order to receive QM status, a Small Creditor loan must meet all QM requirements, *other than the 43% maximum DTI ratio* and without regard to the standards in Appendix Q.
A Small Creditor would still have to verify a consumer’s income and assets and consider the consumer’s DTI ratio and residual income. A qualifying loan would lose its QM status if it is held in the Small Creditor’s portfolio for less than three years, subject to certain exceptions.

The QM Safe Harbor for qualifying loans made by Small Creditors are available on first and subordinate lien loans with an interest rate that do not exceed 3.5% above the APOR for comparable transactions. Exceeding that threshold would mean the creditor would receive the less favorable QM Rebuttable Presumption treatment.

2.5. Small Rural or Underserved Area Creditor Balloon Loans

The ATR Rules provide for another special category of QM Loan treatment for certain balloon payment loans (“QM Balloon Loans”). In the case of a small rural or underserved area creditor, a balloon payment loan may qualify as a QM Loan provided that the loan itself meets certain QM Loan term requirements, and the lender satisfies certain requirements regarding income and obligation verification and evaluation of the borrower’s payment capacity. Such a loan will not be subject to the 43% maximum DTI ratio.

In order to qualify as a QM Balloon Loan, a creditor must meet the requirements to be treated as a Small Creditor for purposes of Small Creditor QM Loans. In addition, the creditor must have extended more than 50% of its total mortgages on properties that are in rural or underserved areas during the preceding calendar year. A qualifying QM Balloon Loan would lose its QM status if it is held in the creditor’s portfolio for less than three years, subject to certain exceptions. The QM Safe Harbor for QM Balloon Loans is available to such creditors on first and subordinate lien loans with an interest rate that do not exceed 3.5% above the APOR for comparable transactions.

QM Balloon Loan treatment will be available to creditors that meet the Small Creditor requirements but that do not meet the rural or underserved area requirements and that otherwise satisfy the QM Balloon Loan requirements. This special transitional treatment will be available for loans made on or before January 10, 2016.
Other Strategic Considerations for Banks Under the ATR Rules

Management should fully analyze the complex choices that the ATR Rules create, evaluating the risks, costs, timing considerations and opportunities presented by each of the options that are available. The board will expect management to make recommendations as to the course of action it believes that the board should select, and explain the record upon which those recommendations are based.

The board of directors should carefully evaluate and probe management’s analysis and recommendations. It should seek advice from outside legal counsel and financial advisors as appropriate.

Once the strategic decisions and product offering decisions are made, the bank will also have to: (i) develop policies and procedures to address compliance; (ii) coordinate with its technology vendors to develop and put systems in place; and (iii) educate its employees and other participants in its loan origination process as to how the bank’s new lending policies and processes will work.

There are also market uncertainties, since the bank may have limited insight in the approaches that its competitors will take, or how loan purchasers, securitizers, investors and other market participants will respond to different categories of loans. Furthermore, there may be significant uncertainties as to the time that major revisions to the mortgage lending system will take to program, test and implement.

A further discussion of these and other issues to be considered follows.

1. The Legal Stress Test to Determine Program Risks

Consider and evaluate the relative degrees of legal risk associated with the three categories of loans. Given the legal uncertainties, a bank may be reluctant to take on a higher degree of potential legal risk at the initial implementation of the ATR Rules, until it has a greater certainty as to how courts will treat borrower claims and defenses. Thus, a bank might decide to initially make only QM Safe Harbor Loans or only QM Safe Harbor Loans and QM Rebuttable Presumption Loans, postponing a decision as to whether to make non-QM Loans to a future time.

In this context, management and directors should understand the legal risks associated with the mortgage programs that the bank decides to offer. That is best done by a legal stress test of the final programs and policies by legal and financial advisors that can ultimately offer the directors detailed analyses of the risks and needed improvements.
2. Underwriting Standards

Consider whether the bank will be able to implement underwriting standards and loan review and approval procedures for non-QM Loans that will be sufficiently robust and demonstrable so as to withstand borrower ATR challenges. Given the turmoil in the mortgage market in recent years, counsel for borrowers are likely to seek to use the Bureau’s factors concerning the historic performance of a creditor’s underwriting standards and the empirical validation of underwriting standards as broad avenues for pursuing ATR claims in regard to non-QM Loans.

Evaluate the extent to which the bank may have to amend, add to or strengthen its underwriting standards. It will also have to consider the extent to which it may have to expand its loan application process to obtain and analyze additional information from a prospective borrower in order to provide further support for the bank’s underwriting and loan review and approval process.

These steps and the resources and time involved also require an analysis of whether the time involved would allow the bank to be ready to commence its mortgage lending program by the effective date of the ATR Rules in January 2014.

Even if a bank plans to limit itself to QM Loans, it will have to reevaluate its underwriting standards in light of the new ATR Rules. As noted above, there are certain underwriting-type requirements, such as a DTI determination and verification requirements associated with a QM Safe Harbor Loan. Consider whether the bank will rely exclusively on satisfying the requirements for a QM Safe Harbor, or whether it wishes to be in a position to demonstrate that it made a supportable ATR determination, in the event that it is found to not qualify for QM Safe Harbor status. A bank may also find that various market participants may require that a lender have such backup protections for QM Safe Harbor Loans in place.

A bank that decides to make QM Rebuttable Presumption Loans will have to address underwriting standards related to qualifying for QM status. It will also have to implement underwriting standards that will satisfy the special requirements that apply to QM Rebuttable Presumption Loans.

3. Vendor Management

Banks will need to work closely with residential mortgage vendors to identify the practical options that are available and the changes to its mortgage origination systems that will be required. The bank and its vendors should evaluate the period of time that will be necessary for the bank to determine what changes it will have to make to origination policies, procedures and protocols, as well as the time it will take for vendors to modify the bank’s systems to accommodate these changes, and then to test and implement the revised systems.

A massive change to lenders’ origination systems will place heavy demands on vendors during the relatively short period until the effective date of the ATR Rules. Banks will have to consider whether those tasks can realistically be accomplished with a high degree of assurance
during the time allowed. It should also have contingency plans in the event it encounters unanticipated obstacles of delays at various points in the implementation process.

Consider the expected and unexpected costs that may be involved in the vendor implementation process and how the bank can best protect its financial interests while achieving its business objectives.

4. **Competitiveness and Profit Potential**

Evaluate the impact of a decision on what types of loans to make and its competitive position in the markets in which it operates. A starting point for this evaluation is an analysis of the percentage of the bank’s current and past lending activity that would have been QM Safe Harbor Loans, QM Rebuttable Presumption Loans, QM Loans that qualify as a Government Related Loans, and non-QM Loans. This may have a significant impact on the bank’s determination of what types of loans it needs to be prepared to make in order to maintain or strengthen its competitive position in the relevant markets.

To the extent that competing lenders are reluctant to make non-QM Loans or QM Rebuttable Presumption Loans this may offer a competitive opportunity for a bank. It may also offer an opportunity for a bank to make loans that have a higher yield because of the additional risk involved.

5. **Ability to Sell Residential Mortgage Loans**

Liquidity in the mortgage markets is a function of the lender’s ability to sell or securitize mortgages that it has originated. Therefore, it will be critical to determine whether there will be differences in the market’s willingness to purchase residential mortgage loans based on how they are categorized under the ATR Rules.

Loan purchasers and other sources of liquidity to lenders will inevitably develop their own standards, reps and warranties and due diligence procedures. But they may be reluctant to buy loans, particularly non-QM loans and QM Rebuttable Presumption Loans, until standards are established and the legal treatment of such loans becomes clearer. Therefore, there will also be timing considerations that impact the mortgage loan products that banks will be able to offer.

These uncertainties will require a bank to evaluate with its board of directors the impact of the ATR Rules on its liquidity plans.

In an important development in this area, the Federal Housing Finance Agency on May 6, 2013, announced that it had directed Fannie Mae and Freddie Mac (the “Enterprises”) to limit their future acquisitions of mortgage loans on or after January 10, 2014, to loans that are (i) QM Loans under the ATR Rule, including loans meeting special or temporary QM requirements, or (ii) are exempt from the ATR Requirements, such as investor loans.¹⁰

¹⁰ FHFA News Release, FHFA Limiting Fannie Mae and Freddie Mac Loan Purchases to “Qualified Mortgages” (May 6, 2013).
With respect to mortgages with an application date on or after January 10, 2014, the Enterprises will not be permitted to purchase any loans if they are subject to the ATR Requirement and are either:

- a loan that is not fully amortizing (no negative amortization or interest-only loans);
- a loan with terms in excess of 30 years; or
- a loan with points and fees in excess of the 3% on the total loan amount rule or other applicable threshold for lower balance loans.

The Enterprises indicate that they will continue to purchase loans that meet their existing underwriting and delivery requirements (including DTI ratio, loan-to-value ratio and reserve requirements) provided that the loan does not fall within one of the three categories described above. As noted above in regard to Government Related Loans, the 43% maximum DTI ratio does not apply to loans that qualify for purchase, guarantee or insurance under this QM status. This exception will terminate on January 10, 2021, except that it will terminate earlier in the cases of Fannie Mae or Freddie Mac if they are no longer in conservatorship.

**6. Ability to Use Residential Mortgage Loans as Collateral**

Consider the extent to which the bank uses or may wish to use residential mortgage loans as collateral for borrowings. For example, many banks obtain secured advances from a Federal Home Loan Bank, using residential mortgage loans as collateral.

Secured lenders, like loan purchasers, will make their own judgments about what types of loans they will accept as collateral and whether and to what extent they may haircut the value that they will attribute to particular types of loans. Secured lenders will also examine the representations and warranties they require and protections that they seek from borrowing institutions. Adverse treatment of non-QM Loans by secured lenders could have a significant negative impact on the attractiveness of such loans to a bank.

**7. Securitization Considerations**

Under the DFA, certain federal agencies are required to issue regulations providing for risk retention requirements for asset backed securities including residential mortgage backed securities (“RMBS”). Proposed rules were issued in April 2011.11 Under these rules, parties that qualify as securitizers will generally be required to retain an economic interest equal to at least 5% of the aggregate credit risk of the assets collateralizing the RMBS.

The DFA allows for an exception from the risk retention requirements for securitizations that are composed of loans that meet the requirements to be treated as a “qualified residential mortgage” loan (“QRM”). The proposed rule provides for a series of tests for a loan to be deemed to be a QRM. These requirements included: (i) a minimum 20% down payment, (ii) a maximum 80% loan-to-value ratio, (iii) monthly housing debt to monthly gross income that does not exceed 28%, and (iv) monthly total debt to monthly gross income that does not exceed 36%. Under the proposed rule, a loan would qualify as a QRM regardless of the foregoing provisions if it is subject to a Fannie Mae or Freddie Mac guarantee.

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The terms of a QRM generally cannot be any broader than the requirements for a loan to qualify as a QM Loan under the ATR Rules. The agencies have held off on issuing final rules awaiting the issuance of the final ATR Rules. It remains to be seen whether and how the agencies will adjust the final QRM requirements to respond to the final ATR Rules.

As a practical matter, if the Fannie Mae and Freddie Mac guarantee option remains available under a final QRM rule, this may provide a securitization outlet for a significant portion of a bank’s residential mortgage loans, likely including some loans that would not otherwise qualify as QRM Loans.

8. Potential Impact on Liquidity

As an institution evaluates the types of loans it will be prepared to make under the ATR Rules, it should analyze the extent that it is likely to be able to sell or securitize various types of loans on acceptable terms, and the extent to which it will be able to borrow on acceptable terms against various types of loans. It will also have to consider how the factors discussed in sections 5 through 7 above may impact the bank’s liquidity capabilities. Given the uncertainties associated with the potential market reaction to various types of loans, banks should consider planning for fall-back contingent liquidity plans in the event that the marketability or collateral value of certain types of loans is less than the bank expected. The board of directors should receive management’s best advice in this regard, as well as those of outside legal and financial advisors.

9. CRA Considerations

The bank should consider what impact various approaches that the bank might take could have on its CRA rating. For example, to the extent that a bank limits its lending programs in light of the implications of the ATR Rules, is that decision likely to have some impact on the bank’s level of lending in its various assessment areas?

If an adverse impact may be expected, the bank should explore taking mitigating actions. For example, it might expand its use of Government Related Loans to seek to maintain its level of participation in potentially impacted assessment areas or with particular borrower income groups. It may also consider taking additional steps that could potentially improve the bank’s performance rating under the investment test to seek to offset a possible adverse impact on its lending test performance rating.

Beyond CRA rating considerations, the bank and its management and board should consider the impact that particular approaches to the loan types that the bank will make under ATR Rules will have on the bank’s participation and engagement in the communities in which it operates and the long-term impact that this may have on its franchise.
10. Fair Lending Considerations

The potential fair lending implications of various ATR Rule options available to the bank may be significant.

If a bank limits its mortgage lending to QM Safe Harbor Loan, it should evaluate what impact that decision will have on loan denial rates among protected groups. To the extent that the decision has a disproportionately adverse impact on protected groups, even if its underwriting policies are facially neutral, it may raise fair lending issues for the bank under recently articulated statements by HUD and the Bureau, as explained below.

Most fair lending cases have been brought on disparate treatment grounds, where the allegation is that similarly situated loan applicants are treated differently as to loan denial and loan terms. A decision to limit loans to QM Safe Harbor Loans could, however, raise issues related to disparate impact discrimination.

Under disparate impact discrimination a bank can be found to have violated the Fair Housing Act (“FHA”) or the Equal Credit Opportunity Act without any showing of discriminatory intent. Disparate impact involves a burden shifting process. First, the plaintiff must show that a lender’s facially neutral policy or practice has a disproportionately adverse effect on a protected group. Then, the burden shifts to the lender to demonstrate that it has a business justification or business necessity for the challenged policy or practice and that there are no less discriminatory alternatives available to the lender to achieve its business objectives. To the extent that the lender carries its burden, a plaintiff may still prevail if it demonstrates that there is another practice that has a less discriminatory effect that the bank could have used to achieve its legitimate, nondiscriminatory business objectives.

Government entities in the fair lending enforcement area have only rarely pursued claims based on disparate impact liability. Recently the government has been showing increasing interest in this area. In September 2012 the Department of Justice (“DOJ”) settled a fair lending claim against a savings institution based on a minimum loan size policy that the DOJ alleged had a disparate impact on protected groups.12 The Bureau issued guidance indicating that it plans to pursue potential claims based on disparate impact.13

In February 2013 the Department of Housing and Urban Development (“HUD”) issued a rule that codified disparate impact liability under the FHA.14 In response to public comments, HUD rejected the need for safe harbors or exemptions for lending policies, including the use of credit scores of compliance with the QM Rule, as neither appropriate nor necessary.

As noted above, a bank that decides to limit its lending to QM Safe Harbor Loans may find that this decision has a disproportionately adverse effect on protected groups. In such a circumstance, the bank should develop strong rationale for why the limitation to QM Safe Harbor is important to achieving legitimate business objectives of the bank and why other less discriminatory alternatives would not adequately achieve those objectives. A bank might

12  DOJ Press Release, Justice Department Reaches Settlement with Luther Burbank Savings to Resolve Allegations of Lending Discrimination in California (Sept. 12, 2012).
cite the higher credit quality associated with QM Safe Harbor Loans, pro-consumer features of such loans and the high level of business and legal risks associated with non-QM Loans. Unfortunately, the government agencies associated with fair lending enforcement have not provided any meaningful indication of what they believe would constitute a sufficient business justification.

A decision to make only QM Safe Harbor Loans could also result in other types of fair lending challenges. To the extent that this approach correlates to a significant disengagement from the bank’s lending in certain communities particularly those with high levels of members of protected groups, a government entity might seek to pursue a redlining type fair lending claim against the bank.

Fair lending issues could arise in other contexts in connection with a bank’s implementation of its response to the ATR Rules. For example, a bank might decide that while it generally will not make non-QM Loans, it will make non-QM Loans to borrowers such as retired persons who have high DTI’s but have high levels of assets. To the extent that the borrowers who get loans under such a program are predominantly not members of protected groups and the borrowers who are not considered for other non-QM Loans that the bank decides not to make are predominantly members of protected groups a government entity might seek to pursue a fair lending claim.
Bringing It All Together

For any bank that has a significant residential mortgage origination or purchase program, the process of developing and implementing the bank’s response to the ATR Rules is likely to be challenging. It will require the full attention and judgment of bank management and the board of directors.

There are a number of key points for a bank to bear in mind.

1. Management should comprehensively evaluate and present the options available, as well as the pros and cons of these options, and recommend alternative strategic approaches.

2. The board of directors should discharge its duties by fully reviewing and evaluating management’s analysis and recommendations, and probing the underlying assumptions, associated risks and rewards associated and the reasons for not pursuing other available options.

3. The bank should consult with legal and financial experts as appropriate to ensure that it is fully considering the risks, rewards and options available to it, including the legal challenges from regulators or third parties that can arise from the mortgage programs that are adopted.

4. Once a mortgage program is developed, a legal and financial stress test of that program can assist management and the board in understanding all the range of risks and attendant costs.

5. The board should hear from management with regard to the bank’s compliance and risk management functions to evaluate the bank’s capacity to effectively deploy proposed recommendations and be able to manage compliance, audit and monitoring.

6. Based on management’s recommendations and the reports of appropriate legal and financial advisors, the board should determine the strategic direction that the bank will take and authorize management to implement its decision, making sure that there is a clear and precise record of what it has decided.

7. Management and the board should monitor the process of implementing the bank’s ATR Rules strategy and any industry or regulatory developments that could call for changes to the bank’s selected strategy.

8. Following the effective date of the ATR Rules, the board should request that management monitor and periodically report on the bank’s implementation of its selected strategy, including its business results, costs, legal consequences and regulatory issues and work with management to adjust the bank’s policies as appropriate.
Impact of Ability-to-Repay and Qualified Mortgage Rules on Residential Mortgage Loan Purchasers, RMBS Participants and Mortgage Industry Investors

Loan originators, their advisors and service providers are moving rapidly to achieve compliance by January 10, 2014 with the Consumer Financial Protection Bureau’s (“Bureau’s”) new rule, which generally imposes an affirmative obligation on mortgage lenders to document a customer’s ability-to-repay whenever a residential mortgage loan is made (“ATR Rule”). The ATR Rule provides certain legal protection from suitability challenges with respect to loans that are treated as qualified mortgages (“QMs”).

The ATR Rule fundamentally changes the U.S. residential mortgage finance market from one that is largely based on a disclosure liability standard, to one that is focused on the suitability of the loan for the borrower. This significantly rebalances the legal relationship between the lender and its borrower, a fact which may impact the value of a residential mortgage and residential mortgage-backed securities (“RMBS”) from several different perspectives. Moreover, mortgage loan purchasers, securitizers, RMBS investors, and equity and debt investors in mortgage-related companies must also consider how the new rule may impact their businesses.

Dechert will soon release “The Investors’ Guide to the Ability-to-Repay Regulation,” which will discuss the legal risks which impact the measurement and pricing of the exposures created by the new rule from the buy side. The insights provided in the Investors’ Guide have been significantly informed by our representation of the American Bankers Association (“ABA”) in regard to the ABA-Dechert publication, “A Strategic Guide to the ATR/QM Rules,” as well as discussions with ABA bank members with regard to the implementation of the ATR Rule.

There is a broader context, which is beyond the scope of this OnPoint. It includes changes that will follow from new mortgage servicing and foreclosure standards, the creation of risk retention requirements for securitizations, and the reconstruction of the secondary markets. Those changes are yet to be fully defined.

What follows is a short summary of the Investors’ Guide.

The Ability-to-Repay Rule: A Game Changer

The Dodd-Frank Act (“DFA”) prohibits a lender from making a covered residential mortgage loan unless the lender makes a reasonable and good faith determination, based on verified and documented information, that, at the time the loan is consummated, the consumer has a reasonable ability to repay the loan according to its terms, and to pay all applicable taxes, insurance and assessments (“ATR Requirement”).

Once the ATR Rule comes into effect, mortgage lenders will have three options:

- Satisfy the requirements for a “QM Safe Harbor” loan to take advantage of the defense it provides to borrower claims for damages or recoupment or offset.
- Satisfy the requirements for a “QM Rebuttable Presumption” loan to take advantage of the lesser
degree of defense provided.

- Offer non-QM ATR loans that will not have the benefit of any special legal protections and would be subject to a case-by-case judicial determination as to whether they satisfy the ATR Requirement.

A discussion of the attributes and protections provided by QM loans is set forth in Appendix A. The defenses that borrowers may assert against the lender in a foreclosure or other non-payment situations and the affirmative actions that they may take seeking damages for alleged violations of the ATR Rule are set forth in Appendix B.

The greater the number of loans that may qualify as QMs, the more loans are likely to be available to prospective borrowers. It is expected that many lenders will be reluctant to make non-QM loans because of the uncertainties about the risks inherent in such loans.

It is notable that the Federal Housing Finance Agency has directed Fannie Mae and Freddie Mac to limit their residential mortgage loan purchases to loans that meet certain QM requirements upon the effective date of the ATR Rule. Specifically, Fannie Mae and Freddie Mac will be prohibited from purchasing any loan that is subject to the ATR Rule and is a loan that (i) is not fully amortizing, (ii) has a term in excess of 30 years, or (iii) has “excessive” points and fees.

Many lenders are likely to build their policies, underwriting standards and portfolios around QM loans in the short run until a knowledge and experience base of ATR lending and court decisions is established.

**Interests of Loan Purchasers, RMBS Investors and Mortgage Finance Entity Investors: Key Risk Evaluation Considerations**

Loan purchasers will need to develop a new approach to their purchasing strategies. As an initial matter, they will have to decide which of the three types of loans they will be prepared to purchase. They will have to consider the extent to which the legal status of a particular type of loan, as well as the associated risks, costs and potential impediments to foreclosure, may impact their purchase and pricing decisions.

RMBS investors will not have the same type of direct contact and negotiating position that loan purchasers will have with lenders. However, RMBS investors must understand the approach that the securitizer has taken with respect to the types of loans that the securitizer has acquired for an RMBS, and how the securitizer, servicer and trustee plan to monitor, mitigate and handle the risks associated with the various types of loans that the RMBS may hold.

Similarly, investors in entities that originate residential mortgage loans and/or that hold significant amounts of such loans must now understand and evaluate the policies that the entity maintains in regard to the ATR Rule. Such investors must also understand how the originator will seek to address and mitigate the risks presented by the particular types of loans that it originates and/or holds in portfolio. To the extent that the lender will originate non-QM ATR mortgage loans, the value of the portfolio will turn on the embedded risks where safe harbor and rebuttable presumption defenses are not available. Similarly, if the lender decides to make only QM loans, then there may be risks of lending discrimination claims that may arise under disparate impact discrimination theory.2

Key considerations that loan purchasers, securitizers, RMBS investors and investors in mortgage-related entities will need to evaluate are set forth in Appendix C.

**Conclusion**

Mortgage loan purchasers, RMBS investors and investors in mortgage finance entities should no doubt try to take advantage of the new opportunities in the marketplace created by the ATR Rule. Indeed, to the extent that financial institutions retreat to the relative safety of QM lending, private capital may fill the void left in the non-QM ATR lending space. Those companies and their investors are facing a rapidly evolving marketplace for residential mortgages, which creates both a challenge and a business opportunity.

In any event, participants in these new markets must evaluate and price the risks inherent in these
transactions. This will result in new templates, standards and terms and conditions to make the markets work as efficiently as possible, but only if we understand the elements of the last mortgage finance crisis will we be able to comprehensively underwrite future markets and avoid the next great mortgage crisis.

Footnotes


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SENATE DISCUSSION DRAFT: HOUSING REFORM STRUCTURE

Federal Mortgage Insurance Corporation

- Facilitate secondary market
- Regulate market MBS guarantors, aggregators, servicers, pm issuers, small lender platform and securitization platform
- Provide government backstop guarantee
- Ensure fairness for consumers
- Supervise FHLBanks

5 Member Board Chairman/Vice Chairman

9 Member Advisory Committee

Office of Underwriting
Office of Consumer & Market Access
Office of ILLBank Supervision
Office of Multifamily Housing
Office of Securitization
OIG

Collateral Risk Managers
Mortgage Insurance Fund (1.25% UPB 5-yr target/2.50% 10-yr target)
Guarantors
Aggregators
PMIs
Securitization Platform 5 Member Board
Small Lender Mutual

Servicers

Dechert LLP
Ability-to-Repay/Qualified Mortgage
Legal Stress Test (ATR Stress Test)
The Challenges

Once the Consumer Financial Protection Bureau’s (Bureau) Ability-to-Repay and Qualified Mortgage rules (together ATR Rules) become effective on January 10, 2014, the bargaining power between lender and borrower will be changed and their respective obligations and liabilities will be restructured. The ATR Rules introduce a federal suitability standard that may provide troubled borrowers with damage claims and an important shield in responding to a foreclosure action, which may encourage the restructuring of delinquent mortgages.

We are pleased to have assisted the American Bankers Association in producing its new Guide for its members entitled *A Strategic Guide to the ATR/QM Rules*, which evaluates the legal, compliance and cost considerations that arise in handling these issues.

Unlike many prior federal actions in this area, the ATR Rules do not merely create new lender disclosure or procedural obligations. They create a fundamentally new paradigm for residential mortgage lending by creating three new categories of loans with very different legal treatments and business and risk implications for lenders. This will change the way that mortgage lending programs are evaluated, implemented and priced. Lenders will be confronted with questions that they will need to properly answer to develop the best record to respond to regulatory and private party challenges.

Other important rules will also take effect next January. The Bureau’s *2013 CFPB Dodd-Frank Mortgage Readiness Guide* warns lenders that they must be ready to roll out lending products that are consistent with Regulation X & Z’s new high-cost mortgage counseling and mortgage servicing rules; Regulation B & Z’s rules regarding appraisals for higher priced mortgages; and Regulation Z’s additional lender compensation rules.

Dechert is helping its clients analyze these new risks and confront the difficult regulatory and governance challenges posed by new residential mortgage rules, so they can maximize their ability to achieve compliance as well as take advantage of the market opportunities also being created.

Critical Questions for Lenders

- What QM and non-QM mortgage products can/should be offered?
- Will the secondary markets and other lenders accept them and what types of representations and warranties will they require?
- What are the legal risks and attendant costs that flow from each new mortgage product?
- What defenses are available to respond to challenges by borrowers, regulators and others?
- How does a lender create the best record to protect management and directors?
- How will the handling of these issues impact future consolidation plans and regulatory relationships?

Dechert’s Bank Regulatory Team

Our bank regulatory team is led by two partners with many years of experience in bank regulatory and mortgage regulation areas.

Learn more at: [www.dechert.com/financial_institutions.](http://www.dechert.com/financial_institutions.)

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The Big Five Risks

As lenders begin to determine the kinds of mortgage products that they will offer, they will find themselves wedged between five risks:

- Compliance with the requirements of the ATR Rules
- Increased chances of a challenge by the government or third parties under evolving fair lending laws
- An increased risk of non-repayment on mortgage loans
- A potential diminishment in the value and liquidity of the mortgage portfolio
- Evolving standards and requirements of the secondary market and collateral lenders

The Role of the Secondary Mortgage Market

Mortgage liquidity, transferability and securitization dynamics will also impact how lenders choose the mortgage products they offer. Given the state of the secondary mortgage market, which is currently dominated by Fannie Mae and Freddie Mac, both of which are in federal conservatorship, this will be an evolving impact. However, if secondary markets determine they only want QM Loans, this will likely be the product that lenders will most frequently offer. In that regard, the Federal Housing Finance Agency has already directed Fannie Mae and Freddie Mac to purchase only loans that generally meet QM Loan requirements. The standards that Federal Home Loan Banks adopt with regard to their collateral requirements for advances and their mortgage purchase programs will also influence the post-ATR Rules development of the mortgage origination market.

Lenders need to keep their fingers on the legal pulse of these developments in order to determine the mortgage lending program that best fits their goals.

Fair Lending Risks

Where lenders refocus their business on making only QM Loans, for example, there is the potential that this will have an adverse impact on the availability of mortgage credit to protected groups. This may trigger investigations or challenges by governmental or private parties on a theory of disparate impact discrimination under the Fair Housing Act and the Equal Credit Opportunity Act. Under disparate impact theory, once a disproportionate adverse impact is shown the burden shifts to a lender to provide a business justification for a facially neutral policy.

The increased exposure to fair lending challenges requires lenders to evaluate the risk, costs and reputational downside of running into problems in this area. For example, in addition to obvious impacts, problems in this area are likely to impact an institution’s ability to engage in acquisitions or to be acquired.

Dechert’s Residential Mortgage Finance Team

In addition to our Banking Team, we have an experienced group that handles residential mortgage loan sales and securitizations.

Learn more at: www.dechert.com/structured_finance.

Ralph R. Mazzeo focuses on mortgage finance and capital markets, with a particular emphasis on structured finance, including residential mortgage-backed securities.

Learn more at: www.dechert.com/ralph_mazzeo.

Dechert’s Fair Lending Team

Thomas P. Vartanian and Robert H. Ledig are co-authors of the treatise The Fair Lending Guide, which became a leading work in the area of fair lending liability under disparate treatment and disparate impact theories, and government and private sector challenges to lenders.

Together, they have handled a number of significant fair lending challenges against a variety of lenders.

For up-to-date information on the QM/ATR Rules and other Dodd-Frank analysis, please visit our Financial Services Reform site at www.dechert.com/FS-Reform.
The ATR-QM Legal Stress Test (ATR Stress Test)

As new mortgage products and compliance programs are developed, institutions should legally evaluate the risks inherent in new lending policies and compliance programs from the perspective of the Big Five Risks if there is to be a reasonable and defensible correlation between products, programs and costs.

Dechert is advising its clients to carefully evaluate these risks and treat them consistent with others in a manner that reflects proper corporate governance, adequate documentation, risk mitigation and maintenance of a safe and sound banking operation. Indeed, the Bureau's Readiness Guide specifically asks whether directors of the company have been properly advised and have reviewed new programs and risks.

We believe that lenders who are in the process of developing or implementing their response to the ATR Rules can benefit from our ATR Legal Stress Test. It will assist lenders and their financial advisors to:

- Understand the legal challenges that may be brought and the potential exposures of officers and directors
- Develop a solid corporate record upon which business decisions may be made that regulators can evaluate
- Present the appropriate options and risk analyses to executive officers and/or boards of directors
- Reach a reasonable level of comfort regarding the extent to which programs, policies and pricing achieve their business and legal goals and anticipate, and deflect administrative challenges and litigation by regulators or private parties

Dechert will work with clients to tailor assistance to the particular needs and circumstances of a client. This may involve, among other things, providing assistance to management or working with management, external financial advisors and consultants, and providing advice to an institution's board of directors.

Our ATR Legal Stress Test product consists of five critical elements:

1. Identification of the range of legal challenges that can be brought by regulators, private parties and other governmental authorities based on the mortgage products, programs and execution policies (Final Product) chosen and implemented by the lender.

2. Cataloguing of available defenses to claims that may be asserted by regulators, private parties including borrowers, and other governmental authorities, and the potential exposures if such defenses are not successful.

3. Recommending Final Product modifications to strengthen defenses against potential legal challenges identified in #1.

4. Recommending Final Product modifications to increase conformity with and acceptance by secondary market, providers of wholesale funding secured by residential mortgage loans and other private parties.

5. Written and oral presentations to management and/or the board of directors regarding the legal risks inherent in the company's mortgage programs, memorializing the results of points 1–4 above.

Costs

Costs for our ATR Stress Test are based on the nature and scope of the assistance that a client decides it would like us to provide. We offer innovative fee agreements that are responsive to client needs and preferences, including flat fees based on the size of the organization.