Federal Reserve Proposes Changes to Regulation Z to Implement New "Ability-to-Repay" Requirement for Residential Mortgage Loans

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On April 20, 2011, the Federal Reserve released a proposed rule that would prohibit a creditor from making a residential mortgage loan without regard to a borrower's repayment ability. The proposed rule would amend Regulation Z, which implements the Truth in Lending Act, to carry out certain reforms mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act.

During the legislative process leading to the enactment of Dodd-Frank, there was substantial testimony before Congress regarding certain lending practices, including a failure to consider a borrower's ability to repay a mortgage loan and the proliferation of low- or no-documentation loans, which purportedly contributed to the rise in subprime mortgage foreclosure rates since 2007. Dodd-Frank addressed these practices by amending the Truth in Lending Act in several important respects, and this latest proposal by the Federal Reserve would make corresponding changes to Regulation Z.

In addition to implementing the new "ability-to-repay" requirement, which is discussed below, the proposed rule (i) implements Dodd-Frank's new limits on prepayment penalties, (ii) prohibits the evasion of Regulation Z by creditors seeking to structure a closed-end extension of credit as an open-end plan and (iii) lengthens the time creditors must retain records that evidence compliance with the ability-to-repay and prepayment penalty rules.

Although the Federal Reserve is soliciting comments on the proposal through July 22, 2011, the proposed rule will be finalized by the new Bureau of Consumer Financial Protection.[1]

A. The Ability-to-Repay Requirement

The Truth in Lending Act, as amended by Dodd-Frank, prohibits a creditor from making a residential mortgage loan unless the creditor makes a reasonable and good faith determination, based on verified and documented information, that, at the time the loan is consummated, the potential borrower has a reasonable ability to repay the loan according to its terms, including all applicable taxes, insurance and assessments. The proposed rule offers creditors four options for complying with this so-called ability-to-repay requirement. The requirement applies to secured residential mortgage loan transactions, but not to open-end credit plans (or home equity loans),

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1 On July 21, 2011, various rulemaking and other functions will be transferred to the Bureau of Consumer Financial Protection, including general rulemaking authority under the Truth in Lending Act. *See* 75 Fed. Reg. 57252 (Sept. 20, 2010) (announcing the "designated transfer date").

timeshare plans, reverse mortgage loans or temporary or "bridge" loans with a term of 12 months or less.

1. <u>Four Options for Compliance</u>

(i) Satisfaction of General Underwriting Standards and Payment Calculation Rules

While there would be no limits on the features, term, points or fees of a particular loan that a creditor may offer, the first option would require a creditor to satisfy general underwriting standards and payment calculation rules.

In making the ability-to-repay determination, a creditor would be required to consider and verify (using reasonably reliable third party records, such as consumer credit reports, IRS tax transcripts and tax returns, financial institution records and payroll statements) the following information pertaining to a potential borrower:

- current or reasonably expected income or assets (other than the value of the home that secures the loan);
- current employment status;
- monthly payment on the mortgage loan;
- monthly payment on any simultaneous mortgage loan that the creditor knows or has reason to know will be made;
- monthly payment for mortgage-related obligations (*e.g.*, insurance, taxes, assessments);
- current debt obligations;
- monthly debt-to-income ratio, or residual income; and
- credit history.

In addition, a creditor would be required to underwrite the mortgage loan payment according to certain assumptions and calculations. Specifically, the proposal requires a creditor to calculate the mortgage loan payment based on (i) the fully indexed rate and (ii) monthly, substantially equal payments that amortize the loan amount over the loan term. However, if the introductory interest rate on a given loan is greater than the fully indexed rate, then a creditor will be required to underwrite the payment based on the introductory interest rate. Special payment calculations would apply in the case of interest-only loans, negative amortization loans and loans with certain balloon payment features.

(ii) Safe Harbor or Presumption of Compliance for "Qualified Mortgages"

A creditor may also make "qualified mortgages," which provide the creditor with a safe harbor from liability, provided that (i) the loan does not have certain features, such as negative amortization, interest-only payments, balloon payments or a term exceeding 30 years; (ii) the total points and fees do not exceed 3% of the total loan amount; (iii) the borrower's income or assets are verified and documented; and (iv) the creditor underwrites the mortgage payment based on the maximum interest rate in the first five years, using a payment schedule that fully amortizes the loan over the loan term and taking into account all mortgage-related obligations.

In lieu of this "safe harbor" approach, the Federal Reserve is soliciting comment on whether a creditor should only have a rebuttable presumption of compliance if it makes "qualified mortgages" that, in addition to satisfying the criteria above, also requires the creditor to consider and verify the potential borrower's (i) employment status; (ii) monthly payment on any simultaneous mortgage; (iii) current debt obligations; (iv) monthly debt-to-income ratio, or residual income; and (v) credit history.

For creditors, the "rebuttable presumption of compliance" approach is clearly less favorable. It requires more individualized determinations and does not provide them with the legal certainty that they would have under the "safe harbor" approach.

(iii) Balloon-Payment Qualified Mortgages Made by Certain Creditors

A small creditor operating predominantly in rural or underserved areas would be permitted to originate qualified mortgages with balloon payment features, provided that (i) the loan term is five years or longer; and (ii) the creditor determines that the potential borrower can make all of the scheduled periodic payments (using an amortization period that does not exceed 30 years and includes all mortgage-related obligations), except the balloon payment, from the potential borrower's current or reasonably expected income or assets (other than the value of the home that secures the loan).

(iv) Refinancing of Non-Standard Mortgages

Under this option, a creditor would be in compliance with the ability-to-pay requirement if it:

- refinances a borrower from a "non-standard" mortgage with risky features to a "standard" mortgage that, among other things, has limits on loan fees and points, lacks features such as negative amortization, interest-only payments or balloon payments and is for a term of no longer than 40 years;
- satisfies the general underwriting standards above (except that the creditor does not have to consider and verify the borrower's income or assets); and
- underwrites the standard mortgage based on the maximum interest rate that can apply in the first five years.

This option only applies where a creditor making the standard mortgage loan is also the holder of the non-standard mortgage.

2. Creditor Liability for Non-Compliance

If a creditor violates the ability-to-pay requirement, a borrower would have the ability to recover damages consisting of the sum of all finance charges and fees paid by the borrower, although such damages could not be recovered if a creditor were to demonstrate that the failure to comply was not material. In addition to any finance charges and fees, a borrower would also be able to recover any actual damages, statutory damages in an individual action or class action

(up to prescribed limits) and reasonable attorney's fees. While the statute of limitations for bringing a claim is three years from the date of the occurrence of the violation, a borrower may assert a violation by a creditor of the ability-to-repay requirement as a defense to foreclosure by recoupment or setoff at any time.

B. Other Proposed Changes

1. <u>New Limits on Prepayment Penalties</u>

Consistent with the amendments to the Truth in Lending Act under Dodd-Frank, the proposed rule amends Regulation Z to provide that a secured residential mortgage loan transaction (excluding an open-end credit plan, timeshare plan, reverse mortgage or temporary loan) may not include a prepayment penalty unless the transaction: (i) has an annual percentage rate that cannot increase after consummation (*i.e.*, a fixed or step-rate mortgage), (ii) is a qualified mortgage (as defined above) and (iii) is not a "higher-priced mortgage loan" (*i.e.*, generally a consumer credit transaction secured by the borrower's principal dwelling with an annual percentage rate that exceeds the average prime offer rate for a comparable transaction, as of the date the interest rate is set, by 1.5 or more percentage points for loans secured by a first lien on the dwelling, or by 3.5 or more percentage points for loans secured by a subordinate lien on the dwelling).

In addition, the proposed rule provides that a prepayment penalty must not apply after the three-year period following consummation of a transaction. Although a prepayment penalty may apply in the first three years after consummation, it may not exceed 3% of the outstanding loan balance during the first year, 2% during the second year and 1% during the third year.

2. <u>Prohibition on Evasion through Open-End Credit Extensions</u>

Currently, Regulation Z prohibits a creditor from structuring a closed-end loan as an open-end plan to evade the ability-to-repay requirement applicable to higher-priced mortgage loans. The proposed rule contains a similar provision in order to prevent evasion of the ability-to-repay requirement applicable to secured residential mortgage loans.

3. <u>Lengthened Record Retention Obligations</u>

Currently, Regulation Z requires creditors to retain evidence of compliance for two years after disclosures must be made or action must be taken. Because Dodd-Frank extends the statute of limitations for civil liability for a violation of the ability-to-repay or the prepayment penalty rules to three years after the date of a violation, the proposed rule would lengthen the record retention requirement under Regulation Z to three years after the consummation of a transaction.

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For more information, please contact a member of Simpson Thacher's Financial Institutions Group.

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