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Dodd-Frank's ability-to-repay rule promulgated by Consumer Financial Protection Bureau

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Many Americans are familiar with the general details of the Dodd-Frank Act and the volumes of new regulations spawned by the landmark legislation, even though many of its effects have not yet been felt. But in January 2014, a specific piece of this wide-ranging reform will hit home for millions of consumers and lenders when a new regulation takes effect that imposes industry-wide standards on the parties to new residential mortgage loans.

Sections 1411, 1412, and 1414 of Dodd-Frank established minimum standards that lenders must fulfill to confirm that the borrower in a residential real estate loan has the ability to repay the loan. Dodd-Frank directs the newly-created Consumer Financial Protection Bureau ("CFPB") to promulgate regulations to ensure that "no creditor may make 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 consumer has a reasonable ability to repay the loan."

In the wake of the financial crisis, lawmakers determined that the pre-crisis methods used by some residential mortgage lenders to verify their borrowers' ability to repay were not commensurate with the perceived industry standards, and as a result, consumers and investors may have wrongly assumed that those lenders were using higher repayment-verification standards than they actually were using. Sections 1411, 1412, and 1414 of Dodd-Frank require the promulgation of a set of standards that consumers may rely upon when they enter into residential mortgage transactions and that investors might also rely upon when they purchase securities backed by residential mortgages. Section 1411 generally requires a lender making a residential mortgage loan to consider "the consumer's credit history, current income, expected income the consumer is reasonably assured or receiving, current obligations, debt-to-income ratio or the residual income the consumer will have after paying non-mortgage debt and mortgage-related obligations, employment status, and other financial resources." Section 1412 grants lenders making certain "qualified mortgages" a presumption that the lender has fulfilled the statutory duty to verify the ability to repay. Section 1414 provides additional standards and requirements to the ability-to-repay rule and the safe harbor provision.

On January 10, 2013, the CFPB issued a final rule implementing the provisions of Sections 1411, 1412, and 1414 and filling in certain gaps as directed by the statute, which will take effect on January 10, 2014. The rule sets forth in additional detail the Section 1411 requirements listed above, and states that lenders must use reasonably reliable third-party records to verify the required information. The rule also outlines certain calculation methods that must be used when determining payments on certain nonstandard mortgages and tries to create incentives for lenders to convert such nonstandard mortgages into standard mortgages.

The rule outlines which mortgages are "qualified mortgages" and as such are presumed to be in compliance with Section 1411 without the need for the production of any additional evidence. If a mortgage loan is not a qualified mortgage, such a loan must be evaluated for compliance with Section 1411 based upon its individual circumstances.

A qualified mortgage must not, among other things, include negative amortization, interest-only payments, balloon payments, a term of more than 30 years, or points or fees exceeding three percent of the loan amount. In terms of underwriting requirements, lender making a qualified mortgage must ensure that the borrower's back-end debt-to-income ratio is less than or equal to 43 percent, with such ratio calculated pursuant to detailed criteria.

The rule provides that qualified mortgages that are prime loans will be conclusively presumed to be in compliance with the ability-to-repay requirement. Qualified mortgages that are subprime loans carry a rebuttable presumption of compliance with the ability-to-repay requirement.

As with many federal regulations, the ability-to-repay rule is riddled with exceptions and nuances. Such detail is beyond the scope of this article, but is critical for lenders and the residential real estate community to become familiar with as the rule's January 2014 implementation draws nearer.

While the ability-to-repay rule is just one aspect to the sweeping financial-industry reforms set in motion by Dodd-Frank, it will soon become one of the most visible aspects of the high-profile legislation once it is implemented and applied to residential lending parties in early 2014.

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