Coming Soon from a Lender Near You: The Qualified Mortgage

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The Dodd-Frank Wall Street Reform and Consumer Protection Act created a new executive agency whose job in part is to establish more stringent criteria for lenders to meet when originating residential loans. A mortgage meeting the new criteria will be considered a "qualified mortgage." The final rule detailing what constitutes a qualified mortgage was released this month by the Consumer Financial Protection Bureau. It is anticipated that the qualified mortgage may become the standard residential mortgage in the banking industry because it offers lenders certain protections from new consumer causes of action created by the Dodd-Frank Act. As a result, it is imperative that lenders and consumers alike understand this new class of mortgage.

Criteria. The Dodd-Frank Act's regulations are designed to ensure that the housing industry does not experience a repeat of the recent mortgage default crisis. In order to ensure that lenders offer loans to persons with a strong likelihood of repaying the loan, the new rules require a lender to verify and document a borrower's ability to repay the loan at the time the loan is originated. Specifically, the lender is tasked with documenting eight items during the underwriting process:

1. Credit history
2. Current employment status
3. Current income or assets

4. Monthly payment for the home loan

5. Monthly payments on other loans tied to the property

6. Monthly cost of other mortgage-related obligations

7. Other debts of the borrower

8. Monthly debt-to-income ratio. A monthly debt-to-income ratio that is no higher than 43% must be met in most cases to qualify.

<u>Excluded Loan Terms.</u> Certain riskier loan provisions that were common in the pre-recession years will prevent a loan from being considered a qualified mortgage. To be considered a qualified mortgage, a mortgage cannot contain interest-only payments, negative amortization (where the principal balance grows over time), a repayment term greater than thirty years, points and fees totaling more than 3% of the loan, or, absent a few exceptions, balloon payments. Again, loans where the lender has not verified and documented the borrower's ability to repay, as described above, will not meet the requirements for a qualified mortgage.

<u>Exempt Loans.</u> Concerned with the effect of bright-line rules upon lenders' willingness to offer loans to anyone but the most qualified borrowers, the Consumer Financial Protection Bureau created a category of qualified mortgages that is not subject to all of the ability-to-repay requirements. However, this category is temporary and it will phase out over a seven-year period. To qualify under this category, a loan must meet the standards to be sold or insured by Fannie Mae, Freddie Mac, the Federal Housing Authority, or the Veterans Administration. Separately, certain balloon payment loans made by smaller community-based lenders in rural or agricultural areas will also be exempt from portions of the ability-to-repay rule. However, these loans must have a minimum term of five years, contain a fixed interest rate, and meet specific underwriting requirements.

<u>Advantage to Lenders.</u> The Dodd-Frank Act created a new legal right for borrowers in foreclosure. If the borrower can demonstrate that the lender failed to verify or document the borrower's ability to repay the loan, the lender can be made to repay the finance charges and fees the borrower had already paid to the lender, plus other damages including court costs and attorney's fees. The borrower can advance this argument as a separate claim against the lender or as an affirmative defense of setoff in a foreclosure lawsuit.

By meeting the new criteria for a qualified mortgage, lenders can claim either a partial (rebuttable presumption) or full defense (safe harbor) against a claim that it did not meet the rule. Whether a lender can claim a partial or full defense largely turns on how far the loan's interest rate is above the prime rate. The ability of a lender to shield itself from this new potential liability is expected to make qualified mortgages a very popular lending instrument.

This final rule of the Consumer Financial Protection Bureau is subject to change following a Spring 2013 public comment period. However, it is expected that the vast majority of the provisions will become effective January 10, 2014, resulting in a dramatic change in the landscape of residential mortgage originations.

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