QM Conundrum

By Wayne A. Whitham, Jr., Esquire, Williams Mullen

CFPB rulemaking is proceeding in numerous areas. In our conversations with bankers, the rules affecting mortgage lending draw the most attention. Some of the rules, those on loan servicing for example, are unlikely to apply to most community banks. Others will be a compliance nuisance, but are not likely to fundamentally affect the ways banks do business.

Two of the rules, however, are likely to affect the way a community bank conducts mortgage lending. One, the ability to repay rule (QM) is drawing a lot of attention, as it should. The second rule, which regulates loan originator compensation, is receiving less attention than it should. Both rules could affect banks that originate mortgage loans for sale in the secondary market differently from those banks that don't.

The ability to repay rule requires lenders to determine reasonably and in good faith, that a borrower can repay before it makes a mortgage loan. A lender must consider eight specific items in reaching its determination. A borrower may sue a lender which reaches its ability to repay conclusion improperly. Damages include all finance charges paid and the borrower's legal fees. Suit can be brought by a borrower up to three years after the loan is made. Damages also can be claimed as a set off against a post foreclosure deficiency claim at any time. A borrower need not be in default to sue a lender. On the other hand, a borrower's default does not establish lender liability.

Until now, protecting your own balance sheet against loss was the incentive you had to assure yourself that a borrower had the ability to repay. Starting in January, if you make a bad mortgage loan, not only might you have a loss of principal and interest, but you might also owe money to the borrower - and his lawyer.

What to do? You could look on the bright side, such as it is. A borrower that claims you violated the law must prove that you did not reasonably and in good faith determine that he had the ability to repay - a possibility in isolated instances, but not usually the case. Besides, how many distressed borrowers will be able to mount the necessary lawsuit or find a lawyer who will take it on a contingency? A bank that follows a prudent underwriting process probably doesn't face great exposure.

If looking on the bright side is too risky, you could steer for a safe harbor - the qualified mortgage. A qualified mortgage automatically satisfies the ability to repay rule. If a borrower sues you under the ability to repay rule and you show that the loan is a qualified mortgage, the case is over and you win. An important issue here is the burden of proof. If the borrower claims you violated the ability to repay rule, he must prove it. If you claim that the loan is a qualified mortgage, you must prove it.

The ability to repay rule does not set loan underwriting criteria, borrower qualifications or loan terms, so what counts is whether or not the borrower has the ability to pay it back. In contrast, a qualified mortgage must meet specific criteria, including a debt to income ratio of 43% or less and full amortization over the loan term. These requirements may make sense insofar as they are attempting to identify loans that are super safe to the borrower. The problem with them is that they force on a lender the choice of abandoning certain markets (balloon loans, for example) or surrendering the qualified mortgage safe harbor.

My best guess is that many community banks will settle on a blend, venturing out of the qualified mortgage safe harbor if customer demand dictates it or when and if banks become better able to assess the risks of ability to repay litigation.

Banks also should focus on the CFPB revisions to the loan originator compensation rules implemented by the Federal Reserve over two years ago. The exposure to a borrower for violating this rule is the same for violating the ability to repay rule. CFPB's revisions are numerous and complicated. Difficult issues include determining who is a loan originator - it can sweep in senior management if you aren't careful - and incentive compensation. If you have incentive compensation plans for employees who aren't mortgage loan officers, but who are "loan originators", it is likely that they violate the rule. My worry is that while violations of the ability to repay rule will be isolated and difficult for a borrower to prove, a bank whose compensation plans don't comply could violate the rule systematically. A bank should analyze which of its employees is a loan originator and, for those who are, make sure that their compensation is within the rule.

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