American Bankers Association®

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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

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About the American Bankers Association

The American Bankers Association (ABA) represents banks of all sizes and charters and is the voice for the nation's $14 trillion banking industry and its two million employees. The majority of ABA's members are banks with less than $185 million in assets. ABA's extensive resources enhance the success of the nation's banks and strengthen America's economy and communities.

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,[1] 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.

1 *Ability-to-Repay and Qualified Mortgage Standards under the Truth in Lending Act*, 78 Fed. Reg. 6408 (Jan. 30, 2013). The Bureau recently amended the ATR Rules. *Ability-to-Repay and Qualified Mortgage Standards Under the Truth in Lending Act*, 78 Fed. Reg. 35430 (June 12, 2013). The Bureau also has an outstanding proposal to amend the ATR Rules, *Amendments to the 2013 Mortgage Rules under the Real Estate Settlement Procedure Act and the Truth In Lending Act*, 78 Fed. Reg. 25638 (May 2, 2013).

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.[2] 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.[3]

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").[4] 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 polices 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.[5] 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.

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).

5 *12 C.F.R. Part 30, Appendix A, C* (OCC); *12 C.F.R. Part 208, Appendix D-1* (FRB); *12 C.F.R. Part 364, Appendix A* (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").

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.

6 *Escrow Requirements Under the Truth In Lending Act*, 78 Fed. Reg. 4726 (Jan. 22, 2013); *High-Cost Mortgage and Homeownership Counseling Amendments to the Truth In Lending Act and Homeownership Counseling Amendments to the Real Estate Settlement Procedures Act*, 78 Fed. Reg. 6856 (Jan. 31, 2013); *Mortgage Servicing Rules Under the Real Estate Procedures Act*, 78 Fed. Reg. 10696 (Feb. 14, 2013) ("Mortgage Servicing Rules"); *Loan Originator Compensation Requirements Under the Truth in Lending Act*, 78 Fed. Reg. 11280 (Feb. 15, 2013).

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.

The Legal Risk is Part of the Bank's Costs

The bank and its management and directors should evaluate the extent to which the bank will be able to defend its mortgage programs from assertions that mortgage products were not suitable and the bank did not appropriately apply the standards of the new rules or otherwise follow its own policies and procedures. Thus, the bank should consider legally stress testing its products and compliance programs once established to identify the specific risks and costs it may be faced with under the rules. In some cases, a defect in the application of either may result in the bank's inability to collect on a mortgage loan or otherwise foreclose in a timely way. These factors affect the value of such a mortgage, which may have serious implications in the secondary mortgage markets. Unless management and directors know the bank's downsides, they will not know how to create safe and sound mortgage programs.

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.[8] 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.

8 ATR Rules, Supplement I to Part 1026—Official Interpretations, Section 1026.43(c)(1).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 its 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 receivorship 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.

11 *Credit Risk Retention*, 76 Fed. Reg. 24090 (Apr. 29, 2011).

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).

13 *CFPB Bulletin 2012-04* (Apr. 18, 2012).

14 *Implementation of the Fair Housing Act's Discriminatory Effects Standard*, 78 Fed. Reg. 11460 (Feb. 15, 2013).

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.

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