ALSTON & BIRD LLP

WWW.ALSTONFINANCE.COM

Global Finance ADVISORY ▪

MARCH 12, 2013

The Consumer Financial Protection Bureau Defines "Qualified Mortgage" for Residential Loans – What Implications Will This Definition Have for RMBS "Put-Back" Litigation?

The Consumer Financial Protection Bureau (the "CFPB") has amended Regulation Z with respect to the Truth in Lending Act, which regulates a lender's ability to make high-risk or high-priced residential mortgage loans.[1] This amendment will serve to implement Sections 1411, 1412 and 1414 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (July 21, 2010) (the "Dodd-Frank Act"),[2] which established, among other things, minimum underwriting requirements for all lenders making residential loans. One of the most notable changes occurring under this amendment is the establishment of a "qualified mortgage" definition.[3] Beginning on January 10, 2014, any residential mortgage loan that meets the standards of a "qualified mortgage" will be presumed to be in compliance with the minimum underwriting requirements of Section 1411 of the Dodd-Frank Act.[4] By creating a definition for "qualified mortgage," the CFPB has also created a minimum standard for all future, private-label, residential mortgage loans.[5] This new regulation will create a safe harbor for all residential lenders, one that could possibly become a jumping-off point for future RMBS "put-back" litigation.

Defining a "Qualified Mortgage"

This new regulation establishes a minimum underwriting standard for residential mortgage loans. Any residential loan consummated on or after July 10, 2014, that fulfills all the statutory requirements to be deemed a "qualified mortgage" will be presumed, under law, to comply with Section 1411 of the Dodd-Frank Act,[6] which requires a lender to consider

---

1 *See* Truth In Lending Act (Regulation Z), 12 C.F.R. § 1026.43.

2 Codified as 15 U.S.C. § 1639c.

3 *See Id*. at (b)(2)(A).

4 *See Id.* at (b)(1).

5 The "qualified mortgage" definition applies primarily to private sector lenders and loan sellers. The likes of Fannie Mae, Freddie Mac and the Federal Housing Administration are exempt from many of the newly codified minimum standards for residential mortgages. *See Id*. at (a)(5).

6 *See Id*. at (e)(1); 15 U.S.C. § 1639c(b)(1).

the borrower's credit history, current income, expected income, debt-to-income ratio or residual income after paying non-mortgage debt and mortgage-related obligations, employment status and other financial resources above and beyond the borrower's equity in the real property or the real property itself that secures repayment of the loan.[7] A lender must also determine the ability of a prospective borrower to repay the loan using a payment schedule fully amortizing the loan over its term.[8] The rule goes on to describe a "qualified mortgage" as any residential mortgage loan:

- where regular periodic payments do not result in an increase in principal and, except for balloon loans under specified circumstances, that does not allow a borrower to defer principal;
- except for balloon loans under specified circumstances, that does not include a balloon payment that is twice as large as the average of all earlier scheduled payments;
- for which income and financial resources of the borrower are verified and documented;
- for an adjustable rate loan, where the underwriting is based on the maximum rate permitted under the loan during the first five years, and where the payment schedule is fully amortized over the loan term and takes into account all applicable taxes, insurance and assessments;
- for which the ratio of the borrower's total monthly debt to total monthly income at the time of consummation does not exceed 43 percent;
- that complies with guidelines or regulations established by the CFPB relating alternative measures of the borrower's ability to pay regular expenses after payment of total monthly debt, taking into account the income of the borrower and such other factors that the CFPB determines relevant and consistent with the lender's purposes;
- for which total points and fees payable in connection with the loan do not exceed three percent of the total loan amount (for loan amounts that are greater than or equal to $100,000 (indexed for inflation)); and
- for which the loan term does not exceed 30 years, except as such term may be extended by the CFPB.[9]

This is not to say that a loan that does not meet the requirements of a "qualified mortgage" is in violation of the Dodd-Frank Act. The "qualified mortgage" provisions simply establish a safe harbor for originators and "by following the criteria, [originators] will have a better chance of shielding themselves from lawsuits from consumers whose loans go bad."[10]

Securitization and the Potential Impact for RMBS "Put-Back" Litigation

Residential and commercial loan originators alike rely heavily on the secondary market. Soon after a loan is originated, it is sold and bundled into a securitization where investors have the opportunity to purchase mortgage-backed securities, secured by the original mortgage loan obligations. Once sold, the originating lender has no further ownership over the loan and the loan is then held by a trust vehicle, for the benefit of the investors. However, once a loan is sold and securitized, the loan originator is not absolved of responsibility or liability for any loan it originated. The courts have been flooded in recent years with put-back claims pursuant to mortgage loan purchase agreements (individually, an "MLPA"). A put-back claim arises when the trust vehicle of a particular securitization of residential loans

---

7 *See* 15 U.S.C. § 1639c(a)(3); 12 C.F.R. § 1026.43(c)(2).

8 *See* 12 C.F.R. § 1026.43(e)(2)(v)(A) (citing (c)(2)(i) & (c)(4)).

9 *See Id.* at (e)(2).

10 Mary Ellen Podmolik, "New Mortgage Lending Rules to Limit Loan Options," *Chicago Tribune*, Jan. 10, 2013.

claims that a loan seller who sold them a particular loan or group of loans breached representations and warranties made in the MLPA with respect to such loans at the time of the sale. If a loan seller breaches a representation and warranty and certain other conditions are satisfied, the seller is typically obligated to then cure the defect or repurchase the loan within a set period of time.

One representation contained in many MLPAs is the representation that the mortgage loans were originated in accordance with the underwriting guidelines of the applicable originator or in accordance with generally accepted underwriting guidelines. As the language suggests, this is a broad and flexible standard, one that naturally varies among lenders and perhaps even among individual loan originators; as we have seen in recent years, this representation can lead to potential liability for loan sellers.[11] However, the existence of the "qualified mortgage" definition may now be viewed as a "baseline" set of underwriting guidelines and thus be used to bring put-back litigation claims. That is not to say that a loan that meets the underwriting guidelines of a "qualified mortgage" will in turn be free from any put-back claims. Just because a loan may meet this minimum standard does not mean that such loan will in turn satisfy any of the other representations and warranties made with respect to that loan.

Further, in addition to affecting put-back litigation, the requirements of a "qualified mortgage" may influence the credit ratings of securitized residential deals in the future. If rating agencies see a new deal that fails to consist in large part of "qualified mortgages," the final rating could be adversely affected. Though "qualified mortgages" are only a safe harbor, those originators who fail to originate "qualified mortgages" may have a difficult time selling those loans into securitizations if such a failure would lower the overall rating of the securitization.

Though likely unintended, defining a "qualified mortgage" may not only create a minimum standard under federal law when it comes to residential loan origination, but may also create a minimum standard when it comes to private and public securitizations. Though these new regulations will only apply to those residential loans consummated after January 10, 2014, time will tell if claimants in ongoing put-back claims will look to the newly codified definition of a "qualified mortgage" as a litmus test for whether generally accepted credit and underwriting guidelines were followed in their own cases. Given the new standard could further influence the rating agencies as they rate new securitizations, we may also see the market representations and underwriting criteria in standard MLPAs amended to reflect such change.

---

[11] *See* Jessica Silver-Greenberg, "Mortgage Crisis Presents a New Reckoning to Banks," *New York Times*, December 9, 2012 (noting that the banks are battling liability from previously originated residential loans "on three fronts: with prosecutors who accuse them of fraud, with regulators who claim that they duped investors into buying bad mortgage securities, and with investors seeking to force them to buy back the soured loans."); *see also* Nelson D. Schwartz, "Bank of America Posts $2.5 Billion Profit, but Mortgage Woes Remain," *New York Times* July 18, 2012 (noting that "[i]nvestors are increasing their demands that Bank of America repurchase soured mortgages" in an amount totaling $22.7 billion in the second quarter of 2012).

If you would like to receive future ***Global Finance Advisories*** electronically, please forward your contact information to **globalfinance.advisory@alston.com**. Be sure to put "**subscribe**" in the subject line.

If you have any questions or would like additional information, please contact your Alston & Bird attorney or any of the following:

Robert J. Sullivan
704.444.1293
robert.sullivan@alston.com

Geoffrey R. Maibohm
704.444.1443
geoff.maibohm@alston.com

Elizabeth Murphy
704.444.1080
elizabeth.murphy@alston.com

ALSTON & BIRD LLP

WWW.ALSTONFINANCE.COM

ATLANTA: One Atlantic Center ▪ 1201 West Peachtree Street ▪ Atlanta, Georgia, USA, 30309-3424 ▪ 404.881.7000 ▪ Fax: 404.881.7777
BRUSSELS: Level 20 Bastion Tower ▪ Place du Champ de Mars ▪ B-1050 Brussels, BE ▪ +32 2 550 3700 ▪ Fax: +32 2 550 3719
CHARLOTTE: Bank of America Plaza ▪ 101 South Tryon Street ▪ Suite 4000 ▪ Charlotte, North Carolina, USA, 28280-4000 ▪ 704.444.1000 ▪ Fax: 704.444.1111
DALLAS: 2828 North Harwood Street ▪ 18th Floor ▪ Dallas, Texas, USA, 75201 ▪ 214.922.3400 ▪ Fax: 214.922.3899
LOS ANGELES: 333 South Hope Street ▪ 16th Floor ▪ Los Angeles, California, USA, 90071-3004 ▪ 213.576.1000 ▪ Fax: 213-576-1100
NEW YORK: 90 Park Avenue ▪ 12th Floor ▪ New York, New York, USA, 10016-1387 ▪ 212.210.9400 ▪ Fax: 212.210.9444
RESEARCH TRIANGLE: 4721 Emperor Blvd. ▪ Suite 400 ▪ Durham, North Carolina, USA, 27703-85802 ▪ 919.862.2200 ▪ Fax: 919.862.2260
SILICON VALLEY: 275 Middlefield Road ▪ Suite 150 ▪ Menlo Park, California, USA, 94025-4004 ▪ 650-838-2000 ▪ Fax: 650.838.2001
WASHINGTON, DC: The Atlantic Building ▪ 950 F Street, NW ▪ Washington, DC, USA, 20004-1404 ▪ 202.756.3300 ▪ Fax: 202.756.3333
VENTURA COUNTY: 2801 Townsgate Road ▪ Suite 215 ▪ Westlake Village, California, USA, 91361 ▪ 805.497.9474 ▪ Fax: 805.497.8804