

# Client Alert

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## Are There Inaccuracies in CFPB's Descriptions of Its Own Regulations?

Regulation Z is over 90,000 words long and creates an ever-expanding array of legal requirements and risks for consumer lenders. Particularly important are the recently enacted rules requiring most lenders to consider mortgage borrowers' ability to repay ("ATR").

To help lenders struggling to understand and implement the complex rules of the Consumer Finance Protection Bureau ("CFPB"), the CFPB has provided various commentaries and guidelines explaining the CFPB's understanding of its rules. There are questions, however, regarding a few of the CFPB's own publications that may be inconsistent with the rules themselves. These discrepancies or ambiguities could expose lenders to litigation risk if they rely on the CFPB's descriptions of these rules—which are not legally binding—and do not look at the rules themselves.<sup>1</sup> These ambiguities and contradictory reasonable interpretations are cause for concern.<sup>2</sup>

### Does the CFPB Inaccurately Describes ATR Treatment of Loan Modifications?

The CFPB has said that lenders need not worry about ability to repay ("ATR") requirements for "loan modifications":

[I]f the transaction does not meet the criteria in [12 C.F.R.] 1026.20(a), which determines a refinancing—generally resulting in the satisfaction and replacement of the original obligation—the loan would not be a refinance under § 1026.20(a), and would instead be an extension of the original loan. In such a case, compliance with the ability-to-repay provision, including a loan's qualified mortgage status, would be determined as of the date of consummation of the initial transaction, regardless of a later modification.<sup>3</sup>

But the ATR rules do not appear to exempt loan modifications from the ATR determination mandate. Indeed, the terms "modification" and "modify" are completely absent from the ATR rules, and it is clear that certain changes to loans—changes that increase interest rates or payments—do require ATR compliance. The ATR rules also do not seem to provide any exemption from ATR requirements for modifications even though those modifications may be exempt from the disclosure requirements provided

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<sup>1</sup> Regulators other than the CFPB may be conducting compliance examinations and they may disagree with the CFPB's non-binding interpretations.

<sup>2</sup> The CFPB's interpretations and guidelines may indicate how the CFPB intends to enforce the ability to repay rules. While these interpretations may be useful for examinations, borrowers also have private rights of action under these regulations, and the judges considering these issues may not agree with the CFPB.

<sup>3</sup> Bureau of Consumer Financial Protection, *Ability-to-Repay and Qualified Mortgage Standards under the Truth in Lending Act (Regulation Z)* at 407 (2013), available at [http://files.consumerfinance.gov/f/201301\\_cfpb\\_final-rule\\_ability-to-repay.pdf](http://files.consumerfinance.gov/f/201301_cfpb_final-rule_ability-to-repay.pdf).

elsewhere in the CFPB's regulations. Why do the new Regulation Z ATR rules lack a specific exemption for modifications that reduce interest rates and payments, like the specific exemption for such borrower-friendly changes to a mortgage found in the Regulation Z disclosure rules?

Ostensibly, the ATR rules apply to any "consumer credit transaction." The CFPB defines "credit" as "the right to defer payment of debt or to incur debt and defer its payment." According to the CFPB's own commentary quoted above, a modification is "an extension of the original loan." Is a loan "extension" a "deferral of payment" that constitutes "credit" as defined by the CFPB? Does this create an issue for workouts of problem credit?

There is a narrow exemption from these ATR requirements for refinancing or modifying a "non-standard" mortgage like an ARM into a "standard mortgage" which cannot be a balloon loan and cannot have a varying interest rate during the first five years. This refinancing exemption will not apply to many credit transactions, such as extending and lowering the interest rate on a matured balloon note. Can lenders assume that such transactions are loan modifications exempt from a new ATR determination requirement, given the apparent narrowness of the exemption that clearly is in the ATR rules? Even though maturity is being extended and payments are being reduced, a new ATR determination may be required under the plain language of the rules.

### **Does the CFPB Inaccurately Discount ATR Risks from Higher-Priced Balloon Qualified Mortgages?**

The CFPB has advised smaller lenders that they need not worry about end-of-term balloon payments even for "higher priced" loans, as long as those loans are qualified mortgages ("QMs"):

You must determine that the consumer will be able to make the scheduled periodic payments (including mortgage-related obligations) other than the balloon payment. Unlike the calculation of balloon loan monthly payments for determining ATR, the Balloon-Payment QM calculation excludes the balloon payment even if the loan is a higher-priced loan[.]<sup>4</sup>

However, the QM calculation is different from the overall ATR calculation. A higher-priced balloon loan is still a higher priced loan that does not fall within the irrefutable safe harbor of automatic ATR compliance. Instead, the presumption of ATR compliance can be rebutted for all higher-priced loans. Where does Regulation Z exempt higher-priced balloon mortgages from the requirement that the lender consider the borrower's ability to make the scheduled payments?

The regulations also do not appear to exempt higher-priced balloon mortgages, qualified or not, from the provision stating that the maximum payment, including the balloon payment, must be considered as part of the ATR determination. Because the mortgaged property itself cannot be a source of repayment, how many borrowers with higher-priced balloon mortgages will meet the ATR test? There is a high risk that the presumption of ATR compliance can be rebutted unless the borrowers have demonstrated the availability of other assets or the existence unusually high income. Thus, should lenders be cautious when issuing higher-priced balloon mortgages, "qualified" or not?

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<sup>4</sup> Bureau of Consumer Financial Protection, *Ability-to-Repay and Qualified Mortgage Rule Small Entity Compliance Guide* at 407 (2013), available at [http://files.consumerfinance.gov/f/201310\\_cfpb\\_atr-qm-small-entity\\_compliance-guide.pdf](http://files.consumerfinance.gov/f/201310_cfpb_atr-qm-small-entity_compliance-guide.pdf).

## **Conclusions & Recommendations**

Proper documentation is the first line of defense for ATR compliance. The regulations call for third-party verification of a number of ATR factors, and these documents should be retained for the duration of the loan in case they need to be used as evidence in defense of the lender's ATR determination. Proper policies for obtaining, evaluating, and retaining such documents and then using that information to make a proper ATR determination are an absolute necessity.

Lenders can further reduce risks by not bucking the guiding hand of the CFPB wherever possible. For instance, as discussed above, lenders may wish to have a policy of doing a full ATR compliance review for all mortgage refinancings and modifications unless the changes qualify for the narrow refinancing safe harbor clearly provided in the new ATR rules.

Lenders may also consider structuring their financial products to take advantage of the non-higher priced qualified mortgage safe harbor created by the CFPB, which provides a non-rebuttable presumption of ATR compliance. At a minimum, lenders may wish to apply careful scrutiny to higher priced mortgages, especially balloon loans, and may wish to offer alternative products that do fit within the non-higher priced qualified mortgage safe harbor while providing lenders with at least some of the advantages of higher priced mortgages. For example, certain lenders may be able to protect against interest rate risks by providing 30-year ARMS that are non-higher priced qualified mortgages as opposed to providing 5-year loans that cannot meet the safe harbor of automatic ATR compliance. Embedded within the ATR rules are certain policy preferences for certain types of loans, and lenders can reduce their risks by submitting to this guidance.

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