A New Frontier: Preparing for Litigation Under the Ability to Repay Rule

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On January 10, 2014, the Consumer Financial Protection Bureau's (CFPB) new Mortgage Servicing Guidelines became effective. One of the more drastic changes under the guidelines is the new "Ability to Repay" rule. This rule states that a lender "shall not make a mortgage loan unless the creditor makes a reasonable and good faith determination at or before consummation that the consumer will have a reasonable ability to repay the loan according to its terms." The rule requires lenders to decide whether a prospective purchaser should take out a loan. The ability to repay rule gives a borrower a cause of action for damages arising from them obtaining a loan that they applied for and accepted, but ultimately could not afford.

Determining whether a borrower has the ability to repay is based on an independent review of the borrower's financial condition. The following factors must be considered:

- Current or reasonably expected income or assets;
- Current employment status;
- The monthly payment on the covered transaction;
- The monthly payment on any simultaneous loan;
- The monthly payment for mortgage-related obligations;
- Current debt obligations, alimony, and child support;
- The monthly debt-to-income ratio or residual income; and
- Credit history.

This is a subjective test. There is no standard for loan originators to rely upon in determining whether a borrower has the ability to repay the loan. Any loan can be subject to attack under the ability to repay rule. The lack of a lending standard will make it difficult for a lender to prevail on summary judgment.

As a result, the CFPB created "qualified mortgages." This designation places limits on the borrower's debt to income ratio and the fees payable by the borrower. The qualified mortgages also bar the use of certain loan features that the CFPB considers harmful to consumers. The barred features include:

- An "interest-only" period;
- Negative amortization;
- Balloon payments (they are allowed under certain circumstances); and
- Loan terms that are longer than 30 years.

The qualified mortgage designation is important. For a low cost loan, a qualified mortgage falls under a "safe harbor" provision protecting the lender from liability under the ability to repay rule. However, a high cost loan (a loan with an APR that was 1.5 percentage points or more over the Average Prime Offer Rate (APOR) at the time of origination) is only entitled to a rebuttable presumption that the loan satisfied the ability to repay requirement.

The ability to repay provision has real teeth. It has a private right of action. In addition, it can be invoked in an affirmative lawsuit up to three years after origination, and it can be invoked as a defense to a judicial foreclosure action. A violation of the ability to repay provisions can result in regular Truth in Lending Act (TILA) damages of actual damages, statutory damages of up to $4,000, costs, and attorney's fees. In addition, the ability to repay damages can include an amount equal to the sum of all finance charges and fees paid by the consumer, unless the creditor demonstrates that the failure to comply was not material.

While the ability to repay rule will only apply to new mortgages, it is such a drastic change that servicers and lenders should prepare now. Here are two issues for lenders to consider in order to limit risks under the ability to repay rule:

Document retention: Claims under the ability to repay rule will be document-intensive and the complete origination file will be needed. If the documents showing the borrower had the ability to repay at the time the mortgage was originated or showing that the loan was a qualified mortgage cannot be located, the ability to defend such a claim will be severely compromised. A new emphasis should be placed on document retention and the timely transfer of the origination documents as the loan is transferred from lender to investor.

Repurchase rights: All mortgage broker agreements, wholesale/correspondent lending agreements, and pooling and servicing agreements should be modified to require warranties that each loan satisfies the ability to repay rule or that each loan is a qualified mortgage. When a claim arises under the ability to repay rule, the lender or investor should proactively exercise its repurchase and indemnification rights to minimize losses arising under this rule.