9575 Katy Freeway, Suite 300

Houston, TX 77024

Phone: 713-871-0005

Fax: 713-871-1358

Thomas E. Black, Jr., P. C. *
Calvin C. Mann, Jr., P. C.
Gregory S. Graham, P. C.
David F. Dulock
Diane M. Gleason
Benjamin R. Idziak **
Shawn P. Black **
Margaret A. Noles
Robert J. Brewer
Regina Uhl
Ali Hedayatifar

Of Counsel
David M. Tritter

** Also Licensed in New York, Washington, West Virginia and Iowa*
*** Also Licensed in New York*

May 11, 2011

To: Clients and Friends

From: David F. Dulock

Subject: Regulation Z Proposed Rule on Consumer's "Ability-to-Repay" to Implement New Section 129C of TILA (76 FR 27390)

In the above-cited May 11, 2011 issue of the *Federal Register*, the Board of Governors of the Federal Reserve System (FRB) published proposed rules (proposed rule) to implement Sections 1411, 1412, and 1414 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The Dodd-Frank Act creates new TILA Section 129C, which, among other things, establishes new ability-to-repay requirements and new limits on prepayment penalties.

If you wish to submit written comments regarding this proposed rule, you must do so by no later than July 22, 2011. The procedures for submitting written comments are located on page 27390 of the above issue of the *Federal Register*.

The following summary of the proposed rule is a redaction of the summary contained in the above-cited issue of the *Federal Register*:

The Dodd-Frank Act amends TILA to prohibit creditors from making mortgage loans without regard to the consumer's repayment ability. These underwriting requirements are substantially similar but not identical to the ability-to-repay requirements adopted by the FRB for higher-priced mortgage loans in July 2008 under the Home Ownership and Equity Protection Act (*see* Reg. Z §226.35).

The proposed rule applies the ability-to-repay requirements to any consumer credit transaction secured by a dwelling, except an open-end credit plan, timeshare plan, reverse mortgage, or temporary loan. Thus, <u>unlike §226.35, the proposed rule is not limited to higher-priced mortgage loans or loans secured by the consumer's principal dwelling.</u>

The proposed rule provides four options for complying with the ability-to-repay requirement. First, a creditor can meet the general ability-to-repay standard by originating a mortgage loan for which:

- The creditor considers and verifies the following eight underwriting factors in determining repayment ability: (1) current or reasonably expected income or assets; (2) current employment status; (3) the monthly payment on the mortgage; (4) the monthly payment on any simultaneous loan; (5) the monthly payment for mortgage-related obligations; (6) current debt obligations; (7) the monthly debt-to-income ratio, or residual income; and (8) credit history; and
- The mortgage payment calculation is based on the fully indexed rate.

Second, a creditor can refinance a "non-standard mortgage" into a "standard mortgage." This is based on a statutory provision that is meant to provide flexibility for streamlined refinancings, which are no- or low-documentation transactions designed to quickly refinance a consumer out of a risky mortgage into a more stable product. Under this option, the creditor does not have to verify the consumer's income or assets. The proposed rule defines a "standard mortgage" as a mortgage loan that, among other things, does not contain negative amortization, interest-only payments, or balloon payments; and has limited points and fees.

Third, a creditor can originate a "qualified mortgage," which provides special protection from liability for creditors who make "qualified mortgages." The proposed rule contains two alternative definitions of a "qualified mortgage."

- Alternative 1 operates as a legal safe harbor and defines a "qualified mortgage" as a mortgage for which:

    (a) The loan does not contain negative amortization, interest-only payments, or balloon payments, or a loan term exceeding 30 years;

(b) The total points and fees do not exceed 3% of the total loan amount;
(c) The borrower's income or assets are verified and documented; and
(d) The underwriting of the mortgage (1) is based on the maximum interest rate in the first five years, (2) uses a payment schedule that fully amortizes the loan over the loan term, and (3) takes into account any mortgage-related obligations.

● Alternative 2 provides a rebuttable presumption of compliance and defines a "qualified mortgage" as including the criteria listed under Alternative 1 as well as the following additional underwriting requirements from the ability-to-repay standard: (1) the consumer's employment status, (2) the monthly payment for any simultaneous loan, (3) the consumer's current debt obligations, (4) the total debt-to-income ratio or residual income, and (5) the consumer's credit history.

Fourth, a small creditor operating predominantly in rural or underserved areas can originate a balloon-payment qualified mortgage. Under this option, a small creditor can make a balloon-payment qualified mortgage if the loan term is five years or more, and the payment calculation is based on the scheduled periodic payments, excluding the balloon payment.

The proposed rule also implements the Dodd-Frank Act's limits on prepayment penalties, lengthens the time creditors must retain records that evidence compliance with the ability-to-repay and prepayment penalty provisions, and prohibits evasion of the rule by structuring a closed-end extension of credit as an open-end plan.

Obviously, the above summary is not a complete description of the proposed rule. For a full understanding we advise you to read the entirety of the proposed rule and the FRB preamble explanation at: http://www.gpo.gov/fdsys/pkg/FR-2011-05-11/pdf/2011-9766.pdf.

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