FROM BUTLER, SNOW, O'MARA, STEVENS & CANNADA, PLLC

QUARTERLY REPORT

MISSISSIPPI REGULATORY COMPLIANCE GROUP

August 2013 Vol. 24 No. 3

CFPB MODIFIES ATR/QM RULE TO ALLOW SOME BALLOON PAYMENT LOANS BY SMALL CREDITORS

On May 29, 2013, the CFPB amended the Truth-in-Lending Act and Regulation Z to finalize a rule aimed at assisting small creditors in originating Qualified Mortgages with the highest level of protection for compliance with the Ability To Repay (ATR) Rule. We discussed these changes in a Bulletin Update on June 4, 2013, but wanted to elaborate a bit on the changes.

First of all, the CFPB made no change with respect to the basic ATR Rule itself. Creditors still must make a reasonable and good faith determination based on verified and documented information that an applicant has a reasonable ability to repay the loan he/she has applied for using the eight underwriting criteria under the ATR Rule still apply.

Making a Qualified Mortgage is still the strongest option available to achieve compliance with the ATR Rule. In general, a Qualified Mortgage priced at an interest rate below 1.5% above the APOR receives "Safe Harbor" status, the highest level of protection for compliance with the Ability To Repay Rule. A higher priced Qualified Mortgage that exceeds that rate but does not exceed 3.5% above the APOR, receives a rebuttable presumption of compliance, a lower level of protection. A loan made under the general ATR Rule that is not a Qualified Mortgage receives no presumption of compliance protection.

As originally issued, the CFPB's ATR Rule created three categories of "Qualified Mortgages":

- A "general" Qualified Mortgage that meets all of the Truth-in-Lending definitions of a Qualified Mortgage;
- A "temporary" Qualified Mortgage which would have to satisfy the ATR requirements of one of the government agencies (e.g., FNMA); and
- A "small creditor" exception for banks with less than $2 billion in assets that originate fewer than 500 covered loans on an annual basis and primarily serve "rural" or "under-served" areas. These small creditors can originate loans with balloon payment features. (neither of the other two forms of Qualified Mortgage can have a balloon payment.)

These three types of Qualified Mortgages have not been changed; however, the changes made by the CFPB in May should give "small creditors" a greater measure of flexibility to originate balloon loans and loans with higher rates that still qualify as a Qualified Mortgage and receive the compliance Safe Harbor. Remember that a "Small Creditor" is any creditor that has total assets of less than $2 billion and that originated fewer than 500 first-lien loans secured by dwelling during the preceding calendar year). The following are the changes.

A new category of Qualified Mortgage has been added for banks that meet the small creditor limitations on asset, size and number of covered loans. This new category of Qualified Mortgage is for certain loans originated and held in portfolio for at least three years (subject to limited exceptions) even if the creditor does not operate predominately in rural or under-served areas. The loan must meet the general restrictions for a Qualified Mortgage with regard to loan features and points and fees, and the lender must still evaluate the consumer's debt-to-income ratio or residual income; however, the loan would not be subject to a maximum DTI percentage. Therefore, a loan could not have negative amortization; or a term longer than 30 years; or points and fees greater than the general limit on points and fees for Qualified Mortgages (3%, etc.). The creditor must consider and verify the applicant's income or assets as well as the applicant's current debt obligations, alimony and child support. While the applicant's debt-to-income ratio or residual income must be considered, the 43% maximum DTI would not apply. The loan must feature payments that are substantially equal and calculated using an amortization schedule that does not exceed 30 years. The loan must have a term of at least 5 years and a fixed interest rate.

Most importantly for many community banks, the CFPB provided a two-year transition period, beginning January 10, 2014, during which a small creditor may originate balloon payment loans held in portfolio with the terms and features listed above without regard to whether the small creditor operates predominantly in rural or under-served areas.

Additionally, the CFPB finalized its earlier proposal to increase the threshold for all small creditors for higher-priced Qualified Mortgage loans from 1.5% above the APOR to no more than 3.5% above the APOR. This change means that loans made by a small creditor with rates that do not exceed 3.5% above the APOR would be granted Safe Harbor status when structured as a Qualified Mortgage. This interest rate relief and additional level of protection is only available for small creditors that fall under the new, fourth category of Qualified Mortgages outlined above.

In addition, the final rule provides an exemption from the ability-to-repay requirements for extensions of credit by certain types of creditors. Creditors designated by the U.S. Department of the Treasury as Community Development Financial Institutions and creditors designated by the U.S. Department of Housing and Urban Development as either a Community Housing Development Organization or a Downpayment Assistance Provider of Secondary Financing are exempt from the ability-to-repay requirements, under certain conditions. The final rule also generally exempts creditors designated as 501(c)(3) nonprofit organizations that extend credit no more than 200 times annually, provide credit only to low-to-moderate income consumers, and follow their own written procedures to determine consumers have a reasonable ability to repay their loans.

While not directly applicable to banks, the final rule also exempts from the ability-to-repay requirements extensions of credit made pursuant to programs administered by a housing finance agency and extensions of credit made pursuant to an Emergency Economic Stabilization Act program, such as extensions of credit made under a state's Hardest Hit Fund program.

Finally, the CFPB clarified the points and fees test for purposes of the Qualified Mortgage and the HOEPA high-cost mortgage requirements. The ATR Rule generally provides that points and fees may not exceed three percent of the loan balance and points and fees in excess of five percent will trigger the HOEPA high-cost mortgage requirements. As originally issued, the CFPB rules would have required compensation paid to a mortgage loan originator to be included in the points and fees calculation. Since most lenders already take the originator's compensation into consideration in setting things like interest rates and origination fees, the original rule would have double counted the originator's compensation in many cases.

The final rule as amended excludes points and fees paid directly by a consumer to a mortgage broker when that payment has already been counted toward the points and fees thresholds as part of the finance charge on the loan. The rule also excludes from points and fees compensation paid by a mortgage broker to its employee. Most importantly, the final rule also excludes from points and fees compensation paid by a creditor to its employee loan originators; however, compensation paid by a creditor to a mortgage broker would still be counted towards the points and fees thresholds.

These changes provide substantial relief for qualifying small creditors that make balloon payment loans. While substantial changes in procedures likely will still be needed to satisfy the ATR Rule, the fact that a small creditor can continue to make balloon loans under the right circumstances and price them reasonably while still receiving Safe Harbor protection should dramatically reduce the overall risk to the bank.

(Ed Wilmesherr)

CFPB AMENDS ATR/QM APPENDIX Q AND MORTGAGE SERVICING RULES

Among the amendments to the ability-to-repay/qualified mortgage (QM/ATR) rule issued by the CFPB on July 10 were changes to the detailed requirements in new Appendix Q for determining whether the consumer's monthly income and debt satisfies the 43% DTI limit for making a qualified mortgage (QM). As originally issued, Appendix Q was modeled on the FHA insurance underwriting manual, and the CFPB acknowledged that some provisions were not well suited to serve as strict regulatory requirements. The CFPB proposed the amendments in April in response to industry concerns in an attempt to ease the compliance difficulties. The amendments also include several changes and clarifications to the mortgage servicing and escrows rules that were issued last January. The amendments will be effective with the effective date of the mortgage rules on January 10, 2014.

<u>Amendments to Appendix Q (Standards for Determining Monthly Debt and Income)</u>.

In order to satisfy the requirements for a QM under Reg. Z, the consumer's DTI ratio may not exceed 43%, and a creditor must use the standards in Appendix Q to verify and document a consumer's income and debt and calculate the DTI ratio. The amendments to Appendix Q deal with several different subjects including: stability of income and the requirement that the creditor evaluate the probability of the consumer's continued employment; the requirement that the creditor also determine whether the consumer's wages, salary or other forms of income can reasonably be expected to continue; creditor analysis of overtime, bonus, self-employment, and social security income; and requirements related to non-employment related income such as trust income and rental/investment property income.

When assessing the stability of a consumer's income, Appendix Q as originally issued required the creditor to evaluate the consumer's probability of continued employment by analyzing, among other things, the consumer's past employment record, qualifications for the job, and past training and education, and the creditor was required to obtain a confirmation from the employer that the consumer's employment would continue. The amendments eliminated those specific requirements. When analyzing a consumer's employment history and stability of income, the creditor must examine the consumer's past employment record verifying employment for the most recent two full years with allowances for school, seasonal employment and explained gaps in employment and obtain confirmation of current employment. A creditor may assume employment will continue if current employment is verified unless the verification indicates otherwise. Stability of income takes precedence over stability of employment, so job changes within the same line of work with advances in income or benefits may be favorably considered.

In one of the more significant changes, the CFPB eased the general requirement that a creditor determine that the consumer's income is "reasonably expected" to continue through at least the first three years of the loan. Under the amendments, the creditor must still determine whether the consumer's income level can be reasonably expected to continue, but the creditor may assume that salary or wage income can be reasonably expected to continue if it verifies current employment and income, and the verification does not indicate that employment has been or is set to be terminated.

The amendments also revise the standards for consideration of overtime, bonus, self-employment and social security income. A creditor will no longer be required to determine whether overtime or bonus income will continue, and may count such income provided it has not received documentation indicating that it will end. Overtime and bonus income can be used if it is documented that the consumer received it for the past two years and the documentation does not indicate it is likely to cease.

As originally issued, Appendix Q would have required social security income to be verified by either the Social Security Administration (SSA) or through Federal tax returns, the creditor to obtain a complete copy of the current awards letter, and the creditor to obtain proof of continuation of payments (for disability benefits, for example). Under the amendments, a creditor is only required to obtain a benefit verification letter from the SSA and may assume that social security benefits will continue and will not expire within 3 years unless the documentation indicates otherwise.

For self-employment income, Appendix Q as originally issued would have permitted the income to be considered if certain criteria were met, including various documentation requirements and analysis of the financial strength of the consumer's business. The documentation included a business credit report for corporations and 'S' corporations, and the analysis required included an analysis of the business's source of income and the general economic outlook of similar businesses in the geographic region. In response to industry comments that business credit reports are costly and difficult to obtain for small businesses and that the analysis would be imprecise, the CFPB eliminated those requirements. The standard as revised is considerably more straightforward – annual earnings that are stable or increasing are acceptable, while income from businesses that show significant decline over the analysis period is not.

The amendments revise the standards pertaining to non-employment related income, such as trust income, income from notes receivable and rental income for purposes of determining and verifying a consumer's DTI. As originally issued, Appendix Q would have permitted consideration of trust income if guaranteed, constant payments will continue for at least the first three years of the loan and then provided a list of required documentation. Under revised Appendix Q, income from trusts may be used in constant payments will continue for at least the first three years of the loan as evidenced by trust income documentation. Required documentation includes the trust agreement or trustee statement confirming the amount of the trust, distribution frequency and duration of payments.

Under revised Appendix Q, notes receivable income may be used if the consumer provides a copy of the note confirming the amount and length of payment and evidence those payments have been consistently received for twelve months through cancelled checks, deposit slips, bank statements or tax returns. If the consumer is not the original payee, the creditor must establish that the consumer is able to enforce the note. As originally issued, Appendix Q would have required the creditor to establish that the consumer was a holder in due course and able to enforce the note.

Under the amendments, a creditor may count rental income from roommates or boarders in the consumer's primary residence as income. As originally issued January, the rule would have prohibited inclusion of this income unless the boarders were related by blood, marriage or law.

Revised Appendix Q permits a creditor to rely on standards established by Fannie Mae or Freddie Mac (GSEs) or by HUD, VA, the Department of Agriculture or Rural Housing Service as "a helpful resource in applying Appendix Q" if those standards are consistent with Appendix Q. In addition, when the Appendix Q standards do not resolve how to treat a specific kind of income or debt, revised Appendix Q allows a creditor to simply choose to "<u>exclude</u> the income or <u>include</u> the debt" or to rely on Federal agency or GSE guidance to resolve the issue.

<u>The GSE/Federal Agency QM Alternative.</u>

The CFPB also finalized amendments to the official commentary to Reg. Z that provide additional guidance on when a loan is considered to be a QM because it is eligible to be purchased by one of the GSEs or to be insured or guaranteed by a Federal agency. In determining eligibility, the CFPB clarified the rule to provide that:

- A creditor may rely on an underwriting recommendation provided by a GSE automated underwriting system (AUS) or compliance with a written guide of a GSE or Federal agency.
- A creditor may also rely on a written agreement between it and a GSE or Federal agency that permits variation from the standards of the written

guides and/or AUSs (so-called "contract variances"). A correspondent lender in a relationship with a sponsor or aggregator that holds a contract variance may also rely on the negotiated contract variance.

- In using one of those methods, a creditor need not satisfy GSE or Federal agency requirements that are "wholly unrelated" to assessing a consumer's ability to repay (e.g., credit risk or underwriting of the loan), such as "requirements related to the status of the creditor rather than the loan, requirements related to selling, securitizing, or delivering the loan and any requirement that the creditor must perform after the consummated loan is sold, guaranteed, or endorsed for insurance such as document custody, quality control or servicing."

Although not included in the actual text of the revised rule or commentary, the CFPB stated in the preamble to the amendments its view that minor inaccuracies in input data that do not affect a loan's eligibility for purchase, guarantee or insurance should not affect the loan's QM status. Further, a repurchase or indemnification demand by a GSE or Federal agency will not automatically strip a loan of its QM status because "[s]ome repurchase or indemnification demands are not related to eligibility criteria at consummation."

<u>Mortgage Servicing Amendments.</u>

<u>Preemption of State Law</u>. The CFPB amended the mortgage servicing rules to clarify the extent to which the loss mitigation and other requirements adopted under RESPA preempt state mortgage servicing and foreclosure laws. Specifically, the CFPB said that state laws that are inconsistent with the federal requirements may be preempted, but state laws that give greater protection to consumers are not. The preemption provision was moved to a new section in Reg. X to make it clear that it applies to all of RESPA and not just the subpart dealing with mortgage settlements and escrow accounts. In addition, the CFPB revised the commentary to state that nothing in the servicing rules should be construed to preempt the entire field of regulation, so creditors will have to comply with both federal and state law in most cases.

<u>ARM Rate Adjustment Notices</u>. The CFPB also clarified that the new notice requirements for rate and payment adjustments on ARM loans apply to existing loans originated before the January 10, 2014, effective date of the rule as well as new loans originated after that date. Of course, no servicer is required to comply with the rule before the effective date.

The CFPB also clarified some of the timing issues on giving ARM adjustment notices in transitioning to the new rules next January. In revised Reg. Z §1026.20(d), the mortgage servicing rules require a new early warning notice 210 to 240 days before the first payment is due after the first interest rate adjustment on an ARM. In the amendments, the CFPB clarifies that servicers will not be required to provide this notice when that new payment is due 209 or fewer days after the effective date of the rule change (*i.e.*, on or before August 7, 2014).

Also under current Reg. Z §1026.20(c), a notice is required 25 to 120 days before the first payment is due after an interest rate adjustment causing a corresponding change in payment. The mortgage servicing rules issued last January revise the content of the § 1026.20(c) notice and require that the notice be provided 60 to 120 days before the new payment is due. In the preamble to the amendments, the CFPB said that "servicers already will have provided the §1026.20(c) notices required by the current rule when such payment is due 24 or fewer days from the January 10, 2014, effective date" (*i.e.*, on or before February 3, 2014). Also, servicers will not be required to provide the § 1026.20(c) notice when such payment is due 25 to 59 days from the effective date" (*i.e.*, from February 4 through March 10, 2014). It seems highly unlikely the CFPB really means that no notice is required for new payments that come due during this time period, and it would be wise for servicers to provide either the current or revised § 1026.20(c) notice in accordance with their schedule prior to the rule change (at least 25 days in advance).

<u>Exemptions for Small Servicers</u>. A servicer that services 5,000 or fewer mortgage loans that it or an affiliate originated or owns is a "small servicer" and therefore exempt from some of the more burdensome requirements of the mortgage servicing rules including the requirements for periodic statements and some of the requirements regarding loss mitigation and lender-placed insurance. In the amendments, the CFPB clarified what loans must be counted when making this determination. Specifically, all dwelling-secured closed-end consumer credit transactions must be counted, and not just "federally related" mortgage loans under RESPA, plus all such loans serviced by any affiliate of the servicer.

ESCROW RULE AMENDMENTS

The amendments announced by the CFPB on July 10, 2013, also gave some additional guidance on the Bureau's recent amendments to the escrow rule which took effect on June 1, 2013. So now, we have amendments to the amendments, but at least the change is a helpful clarification. Specifically, the amendments clarify that construction loans, bridge loans and reverse mortgages are not subject to the rule's requirements regarding the ability-to-repay requirements and prepayment penalty provisions for higher priced mortgage loans ("HPMLs").

When the CFPB issued the escrow rule in January 2013, it revised the definition of the term "higher priced mortgage loan" by removing the exclusions for transactions to finance the initial construction of a dwelling, temporary or bridge loans with a term of twelve months or less and reverse mortgages from the definition. The Bureau removed those exclusions from the general definition of HPML and located them in the individual provisions regarding appraisal, escrow, ability to repay and prepayment penalty requirements. Then, in writing the amendments to the 2013 escrow rule that were issued in May, the Bureau changed some section numbering, and it is now concerned that the section re-numbering could have given the impression that the exclusion for construction loans, bridge loans and reverse mortgages from the HPML ATR and prepayment penalty requirements no longer applied. The latest amendment is to clarify that the exclusion continues to apply.

PROPOSED AMENDMENTS TO INTERAGENCY APPRAISAL RULE

Separately, on July 10, 2014, the federal bank regulatory agencies issued proposed amendments to their January 2013 final interagency appraisal rule. That rule requires creditors making HPMLs to obtain one or more written appraisals and to provide consumers with a notice regarding the use of appraisals and a free copy of each appraisal. The agencies are proposing to amend the rule to exempt the following transactions from these requirements:

- Transactions secured solely by an existing manufactured home with no land;
- "Streamlined" refinances where the borrower or guarantor on the refinance is the current borrower or guarantor on the existing loan, provided that the payments on the refinance are not interest-only and do not result in negative amortization or a balloon payment, and no new money is advanced; and
- Transactions of $25,000 or less (with that amount increasing annually based on inflation).

The deadline for comments is September 9, 2013.

(Cliff Harrison)

MORTGAGE LOAN ORIGINATOR COMPENSATION

On July 23, 2013, the Consumer Financial Protection Bureau ("CFPB") filed a complaint against Castle & Cooke Mortgage, LLC (the "Company") alleging violations of the mortgage loan originator compensation rules. More specifically, the CFPB alleged that the Company paid quarterly bonuses to mortgage loan originators based on the interest rates on loans originated by each loan originator. According to the CFPB, the Company's mortgage loan originators had an incentive to increase the interest rate on mortgage loans in order to receive a larger bonus; thus, steering borrowers into loans with higher interest rates. In its complaint, the CFPB alleged that the Company paid more than four million dollars in bonuses between July 8, 2011 and April 27, 2012.

The complaint goes on to address the Company's written compensation policies and individual compensation agreements with loan originators. The CFPB claims that its review of the Company's compensation practices did not reveal any written documentation of the bonus program or of the Company's method for calculating bonuses.

In response to the complaint, the Company's president noted that only 10% of their employees were eligible for bonuses in 2012 and five set criteria are used in making the determination of bonus eligibility. According to the Company's president, in order to be eligible for a bonus, a mortgage loan originator must: (1) close nine or more loans per quarter; (2) meet certain quality-control standards; (3) meet or exceed a ratio of 70% of loans that are actually funded; (4) be a current employee of the Company; and (5) maintain a portfolio of performing loans without early payment default.
This recent complaint prompted us to reiterate some points from the CFPB's final regulations issued on January 20, 2013, implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act provisions concerning loan originator compensation practices (the "Final Rule"). Regulation Z currently prohibits banks from compensating its mortgage loan originators on "any of the transaction's terms or conditions," such as the interest rate. The Final Rule also prohibits compensation based on any "proxy" of a term of a transaction. The Final Rule defines "a term of a transaction" as "any right or obligation of the parties to a credit transaction." Compensation is defined in the Final Rule as "salaries, commissions, and any financial or similar incentive." Therefore, a bonus payment is treated as compensation for purposes of the Final Rule.

As previously mentioned, the Company did not document its compensation practices in a policy or in individual compensation agreements with mortgage loan originators. Records "sufficient to evidence all compensation" paid to a mortgage loan originator must be retained for three years after compensation is paid. Sufficient records include those that demonstrate the type and amount of the payment; evidence that the payment was made and to whom; evidence that the payment was received and by whom; and when the payment was made and receipt of confirmation was obtained. The type of documentation necessary will depend on the type of compensation payments made.

The Final Rule prohibits the payment of compensation based on the profitability of a transaction or a pool of transactions or overall profitability of a department or organization that includes profits from covered mortgage loans. However, there is an exception for contributions to "designated tax –advantaged" plans such as 401(k)s, employee annuity plans, simple retirement accounts, simplified employee pension and eligible deferred compensation plans, all as defined in the Internal Revenue Code.

Bonuses paid based on the profitability of a transaction or pool of transactions can be made under certain non-deferred incentive plans only if the payment is not based on a term or transaction of the loan originator's transactions and (1) the bonus does not exceed 10% of the total compensation received for that period (including the bonus payment) or (2) the individual was a loan originator for 10 or fewer transactions during the preceding 12 months.

The time period used for determining whether a payment will exceed the 10% cap is the time period during which the profits on which the bonus is based were earned. For example, if a loan originator will receive a bonus based on profits generated in 2012, then the calculation will include his 2012 compensation and the bonus payment even if the bonus will not be paid until January 2013. However, if the same loan originator will receive a bonus based on 2013 profits, but will be paid in early 2014, then the bonus payment paid in January 2013 (based on 2012 profits) should not be included in the 10% calculation for the bonus based on 2013 profits.

The 10% maximum compensation amount is only applicable to compensation based on profits generated from mortgage loans. A bonus or contribution made based on profits generated from any other bank activity is not subject to the 10% cap. If a bonus is paid based on profits from a specific area of the bank, such as an individual branch, then the bank will need to determine the percentage of profits earned from mortgage loan originations prior to determining the bonus amount if the total bonus to be paid would exceed the 10% cap. The bonus amount based on mortgage profits may not exceed 10% of the loan originator's total compensation, but a bonus based on profits earned from other branch activities will have no cap.

That calculation can get complicated, depending on the situation. For example, if a bank wanted to pay a branch manager an annual bonus based on overall branch (or bank) profitability in an amount that would be more than 10% of the branch manager's total compensation for the year, then the bank would need to make a determination of how much of that bonus was attributable to profits from covered mortgage loans if the branch manager originated more than 10 mortgage loans during the year. That determination is generally going to require some sort of calculation showing how the bonus pool was determined and may involve allocating overhead and expense between mortgage lending and other lines of business (deposits, other loans, etc.) so that the profitability of the mortgage lending business and, therefore, the portion of the bonus pool and individual branch manager's share of the pool that comes from mortgage profits can be determined. As the CFPB enforcement action against Castle & Cooke demonstrates, documentation of that determination will be extremely important.

(Memrie Fortenberry)

A LOAN POLICY FOR ATR AND QM

At the August Quarterly Meeting, we will present and discuss a very general outline of a Generic Loan Policy for the Ability to Repay and Qualified Mortgage Rules. In order to facilitate that discussion and make that time as productive as possible, it seems advisable to provide a basic description of what that outline will entail. Here is where we begin to put on our thinking caps.

Between now and January 10, 2014, every bank that is subject to the Ability To Repay Rule will be faced with a basic decision: whether or not to originate Qualified Mortgages. We have already spent a lot of time and discussion considering what is required under the Ability to Repay Rule and what it will take for a loan to be a Qualified Mortgage. As we think about developing an outline of a Loan Policy for the ATR and QM Rules, we will only make passing reference to many of those requirements. Please refer to earlier Newsletter Articles and materials from our previous quarterly meetings for a more detailed analysis.

As you approach this task, you will be faced with an initial set of three options:

- Option 1: only originate Qualified Mortgages;

- Option 2: originate Qualified Mortgages when possible to do so, but also originate loans that will merely satisfy the Ability To Repay Rule if the customer or the loan in question cannot be structured as a QM; or

- Option 3: originate all loans focused only on satisfying the Ability To Repay Rule.

By now, I am sure everyone realizes that Option 1 is the most risk-free. A portfolio of nothing but Qualified Mortgages should entitle the bank to either a Safe Harbor or a presumption of compliance with the Ability To Repay Rule.

Option 2 is somewhat riskier since only a portion of the Bank's portfolio will be Qualified Mortgages subject to Safe Harbor or a presumption of compliance. The remaining Non-Qualified Mortgages will have to fully and completely satisfy the Ability to Repay Rule, with significant liability attaching to any loan that fails to meet ATR requirements.

Option 3 is very risky. Every loan must fully satisfy the ATR and there will be no presumption of compliance or Safe Harbor available. Examiners will see this as a significant risk, and they will be right.

The bank that chooses Option 1 will then have an additional series of elections to make because there are several avenues available to originate Qualified Mortgages. Those additional options are:

- Option 1-A: The General Qualified Mortgage;

- Option 1-B: The Small Creditor Balloon Payment Qualified Mortgage;

- Option 1-C: The Temporary Authority Qualified Mortgage; or
- Option 1-D: The Small Creditor Portfolio Qualified Mortgage.

Each of the options for originating Qualified Mortgages is discussed below.

OPTION 1A: The General Qualified Mortgage.

Loans originated under the General Qualified Mortgage Option must have the following limitations, terms and conditions:

Prohibited Terms: loans made pursuant to the General Qualified Mortgage Option will not feature:

- Negative amortization or interest only payments;
- Balloon payments; or
- A loan term in excess of 30 years.

Limit on points and fees. Loans made under the General Qualified Mortgage Option may not have points and fees which exceed:

- 3% of the total loan amount for a loan greater than or equal $100,000;
- $3,000 for a loan greater than or equal to $60,000, but less than $100,000;
- 5% of the total loan amount for a loan greater than or equal to $20,000 but less than $60,000;
- $1,000 for a loan greater than or equal to $12,500, but less than $20,000; or
- 8% of the total loan amount for a loan less than $12,500.

Regular Periodic Payment Requirements. Loans made under this Option must provide for regular periodic payments of substantially equal amount that do not result in an increase in the principal balance, allow deferment of principal payments, or result in a balloon payment.

Mortgage-related Obligations. Loans made pursuant to this Option must be underwritten based on the applicant's ability to make, not only the required monthly payment needed to repay the loan itself, but also the monthly payment for all mortgage-related obligations (e.g., taxes, insurance premiums, etc.). Information related to these obligations must be obtained and verified.

Underwriting the Required Payment. The required payment must be underwritten using the maximum interest rate that may apply during the first five years of the loan; and periodic payments of principal and interest that will either repay the outstanding principal balance over the term of the loan using the aforesaid maximum interest rate, or the loan amount over the loan term.

Income or Assets. An applicant's current or reasonably expected income or assets must be considered and verified.

Employment Status. The applicant's employment must be considered and verified.

Current Debt Obligations, Alimony, Child Support. The applicant's current debt obligations, alimony and child support payments must be considered and verified.

Debt-to-Income Ratio. After considering and verifying an applicant's total monthly debt and total monthly income, the two must be compared and an applicant must have a debt-to-income ratio of no more than 43%.

OPTION 1B The Small Creditor Balloon Payment Option. For those small creditors that qualify (have less than $2 billion in assets, fewer than 500 covered loans in the previous year and 50% or more of those loans originated in "rural" or "underserved" counties) this option 1B will be available.

These loans cannot have negative amortization and cannot have terms in excess of 30 years. Like the General Qualified Mortgage these loans must also satisfy the same Points and Fees limitations.

The Small Creditor Balloon Payment Loans will then have to be underwritten and documented using the applicant's reasonably expected income and considering the applicant's current debt obligations, alimony and child support obligations. These criteria must be documented and verified, but these loans will not have to adhere to the standards set forth in Appendix Q of Regulation Z as other Qualified Mortgages must. These loans must be underwritten using loan payments of equal amount and an amortization that does not exceed 30 years. The minimum term of the loan must be for at least 60 months plus the balloon payment that follows.

OPTION 1C Temporary Authority Qualified Mortgage. This option will allow a bank to originate Qualified Mortgages using the ATR criteria of one of the GSE's (FNMA, GNMA) or a government agency (HUD, VA, USDA, etc.). This option could be attractive to a bank that has access to, or is familiar with, the automated underwriting processes used by these entities. A qualified mortgage of this type must not:

- Allow negative amortization;
- Feature interest only payments;
- Result in a balloon payment;
- Exceed a term of 30 years; or
- Exceed the points and fees limitations.

OPTION 1D Small Creditor Portfolio QM's

To be eligible to originate dwelling-secured loans using this option, a bank must have total assets of less than $2 billion and cannot have originated more than 500 covered loans in the previous calendar year; however, it is not required to originate any certain percentage of its loans in "rural" or "under-served" counties.

Loans that use this option must not feature negative amortization or permit interest-only or balloon payments. Payments on the loan must be substantially equal and cannot have a term that exceeds 30 years.

The same points and fees limits that apply to other types of Qualified Mortgage loans will apply here.

Underwriting of these loans must take into account the monthly payment using the highest interest rate that can apply during the first five years and periodic payments of principal and interest that will repay the loan over the term of the loan. Mortgage-related payments must also be taken into account.

Current and reasonably expected income and assets must be considered and verified, but the standards contained in Appendix Q do not have to be observed.

Current debt obligations, alimony and child support must be considered and verified. A debt-to-income analysis must be performed, but the 43% debt-to-income ratio that applies to other Qualified Mortgages does not apply to these loans so long as it can be determined that the applicant has sufficient resources to make payments and sufficient residual income to provide necessary support.

OPTION 2: Bank's choosing this option will originate some loans as Qualified Mortgages and others that simply satisfy the Ability To Repay Rule. These banks will have to choose their method of originating Qualified Mortgages from the Options 1A through 1D above and then look to the following general procedures for originating loans that simply underwrite for the Ability To Repay Rule (Option 3 below)

OPTION 3: In order to originate a consumer loan that is secured by a dwelling, including any real property attached to the dwelling, the bank must first make a reasonable and good faith determination that the loan applicant will have a reasonable ability to repay the loan applied for according to its terms.

To do so, each loan must be underwritten for the following criteria.

- Income or assets. The bank must consider the applicant's current or reasonably expected income or assets, other than the value of the dwelling, including any real property attached to the dwelling.
- Employment status. If the applicant's income is relied upon as a source of repayment, the bank must determine and verify that applicant's current employment status.
- Monthly payment. The repayment ability must be determined using the monthly payment of the loan that is applied for and the payment calculation methods set forth below.
- Monthly payment on simultaneous loans. Any payments on simultaneous loans that the bank is aware of must be included when considering the overall ability to repay.
- Mortgage-related obligations. The monthly payment for mortgage-related obligations such as taxes, insurance PMI or condominium dues and assessments must be considered.
- Other obligations. The applicant's debt obligations in the form of a monthly payment, alimony and child support must be determined and considered.
- Debt-to-income ratio. A debt-to-income ratio must be calculated or an assessment of residual income after meeting all currently monthly obligations must be determined and considered.
- Credit history. Finally, the applicant's current credit history must be determined, verified and considered.
- Verification. Each of the underwriting criteria listed above must be verified using reasonably reliable third party records and following the techniques below:
- Verification of income or assets. The income or assets of an applicant may be determined and verified using any, or some combination, of the following:
    - Copies of tax returns;
    - IRS Form W-2s;
    - Payroll statements; etc.
- Verification of employment. Oral confirmation of an applicant's employment by the employer will suffice; however, a written record of

the oral confirmation must be placed in the applicant's file.

- Current debt obligations. [optional] A current credit report for each applicant will be used to independently determine and verify both the debt obligations that each applicant has and the applicant's current debt history.

- Payment calculation. The bank must verify the applicant's ability to make the payment required if his or her loan is approved. The payment must be calculated using the fully indexed rate and substantially equal monthly payments that amortize the loan. If the loan is originated with a balloon payment feature, then the maximum payment scheduled during the first five years after the date on which the first regular periodic payment will be due must be used, provided that the loan is not a "higher priced" loan (i.e. does not have a rate of interest that exceed the APOR by 1.5% or more for first-lien loans or 3.5% or more for subordinate lien loans). However, if the loan falls into the category of a "higher priced" loan as explained above, the loan must be underwritten for the full amount of the balloon payment, excluding the value of the dwelling. NOTE: It will be an unusual situation where an applicant is able to repay a higher-priced balloon payment loan without resorting to the sale or refinancing of the dwelling that serves as collateral.

[Drafting notes:]

1. The Bank is required to retain sufficient evidence to demonstrate compliance with the documentation requirements of the Ability to Repay and Qualified Mortgage Rules for a minimum of at least three (3) years following consummation of the loan. Adequate evidence of compliance does not necessarily mean paper copies of the required records. These records may be retained by any method that accurately reproduces those records on a prompt basis. Care should be taken when detailing the methods that will be used to obtain, consider, verify and retain in accessible form the information needed for consideration when making a Qualified Mortgage, or when simply documenting compliance with the Ability to Repay Rule if the loan is not eligible for Qualified Mortgage status.

2. Almost certainly the bank should retain the above-referenced documentation in a retrievable format for longer than the minimum three (3) year period.

3. In light of the significant risks associated with any violation of the Ability to Repay Rule or the Qualified Mortgage Rule, it is vital that the Bank put in place controls to assure that all covered loans are underwritten using each and every one of the required underwriting criteria. It is equally important that every loan satisfies the points and fees test and otherwise complies with the requirements and limitations imposed on Qualified Mortgages. And finally, there should be controls to assure that every loan file contains the verified third-party documentation to prove that loans comply with the Ability to Repay and Qualified Mortgage Rules. Careful consideration should be given to the type and degree of post-loan

closing procedures, monitoring and review that should take place.

4. This generic Qualified Mortgage Loan Policy does not attempt to address the policies, practices, and procedures that you will need to adopt in order to satisfy the requirements for verification and documentation of required underwriting information such as income, assets, employment, debt obligations, alimony, child support, etc. since those practices will differ from one institution to another.

5. This draft policy does not address the policies that may be needed to monitor and review each loan either at or after closing, in order to determine that all requirements for a Qualified Mortgage have been satisfied and that a sufficient retrievable record of the collection and verification of required information has been established.

6. No effort has been made to establish loan pricing guidelines, other than to say that every loan closed as a Qualified Mortgage must meet the limits for fees and charges established by law and regulation. Where within those limits your pricing will fall should be an individual consideration for each Bank.

7. The same approach holds true for interest-rate pricing of Qualified Mortgages; however, one important point bears mentioning: recent changes to the Qualified Mortgage provisions of Regulation Z allow certain small creditors to originate Qualified Mortgages with higher pricing than was originally proposed and still receive so-called "Safe Harbor" protection for compliance with the Ability to Repay Rule. These loans fall into two (2) categories:

a. Loans originated by creditors with assets of less than $2 billion and less than 500 total covered loans originated in the previous calendar year, but not limited with respect to percentage of loans originated in "rural" or "under-served" counties. These loans must be first-lien loans and must be held in the Bank's loan portfolio. They cannot feature a balloon payment, and they must otherwise meet the requirements for Qualified Mortgages set out in the applicable Option selected above. Then, if all of these requirements and limitations are met, that first-lien loan can be priced at an interest rate that is less than 3.5% above the APOR and still qualify for Safe Harbor Protection.

b. For a two-year period beginning January 10, 2014, creditors with total assets of less than $2 billion and that originated fewer than 500 dwelling-secured loans in the previous calendar year, may originate balloon payment loans without regard to whether a certain percentage of those loans are originated in "rural" or "under-served" counties, so long as all of the requirements listed in Option 1B are observed. These loans may also be priced at a rate equal to the APOR plus 3.5% and still receive "Safe Harbor" treatment.

(Ed Wilmesherr)

THIRD PARTY SERVICE PROVIDER RISK ASSESSMENT

Vendor management and third party service provider oversight has become an increasingly important area for banks to closely consider and regularly monitor. Banks are responsible for the practices of third parties and may be held accountable for a third party's violations of consumer protection laws and regulations as well as unfair, deceptive and abusive acts and practices. Regulators have increased their focus on third party contracts and activities and are requiring banks to conduct a risk assessment of each third party relationship, put policies and procedures in place for the management of these relationships and maintain documentation of all initial and ongoing due diligence and monitoring.

In one of its first enforcement actions, the Consumer Financial Protection Bureau (CFPB) cited American Express Centurion Bank with violations of deceptive debt collection, deceptive marketing, excessive late fees, inadequate credit dispute reporting and lack of proper oversight of the bank's management and board. In the Consent Order, it was noted that all but one of the cited violations resulted from "deficient management oversight of the bank's service providers." The Consent Order required the Bank "to develop policies to maintain effective monitoring, training, record-keeping and audit procedures to review each aspect of the Bank's agreements with its Service Providers and the services performed for the Bank pursuant to these agreements."

In response to the increased scrutiny on vendor management practices, all banks should conduct a risk assessment of each third party relationship. The risk assessment should be performed not only as part of the initial due diligence conducted prior to entering into a new third party relationship, but also on an ongoing basis for periodic monitoring.

We have developed a third party risk assessment for participants in the CMS Initiative. In doing so, we focused on the following subject areas: due diligence; policies, procedures, oversight and control; the contract; and products and services. A summary of considerations for each subject area is set forth below.

<u>Due Diligence</u>

Conducting adequate due diligence is extremely important prior to entering into a new contract with a third party, but it is equally important and necessary to conduct ongoing monitoring and to remain comfortable with each service provider's practices throughout the relationship. In other words, due diligence should be an ongoing task. Adequate due diligence is of even greater importance when considering certain types of products and services such as those for identity theft protection and others that have been under increased scrutiny. The third party's financial information, experience, reputation, consumer complaints, litigation, controls, security procedures, business plans, business resumption strategy, knowledge of existing laws and regulations, and many other relevant issues and documents must be reviewed and considered in order to conduct adequate due diligence.

<u>Policies, Procedures, Oversight and Internal Control</u>

Appropriate and adequate personnel should be included in every step of the monitoring of third party relationships. Specific employees should be assigned the duties of ongoing oversight and monitoring of third party relationships. Management should be immediately notified of any issues, modifications or other concerns involving existing relationships. Management insight and Board approval should be obtained prior to entering into a new agreement.

Any incentive for bank employees to encourage customers to sign up for a new product or service should be eliminated. The use of incentives is strongly discouraged and such practices have been the basis for serious UDAAP related enforcement actions.

Issues surrounding consumer complaints should be addressed in every contract. The parties must agree as to which party will have responsibility for responding to consumer complaints, how complaints will be forwarded to the appropriate party for response, and the development and maintenance of complaint summary reports.

Contract Review

Each contract should clearly set forth the expectations, obligations, and rights of each party. Each contract should also contain an indemnity provision. This provision should be drafted in the bank's favor and the bank should assume no more risk than the third party. It is important to note that an indemnification provision, no matter how well drafted, should not be viewed as a way to avoid practicing safe and sound banking practices.

The contract should address authorization for continued due diligence and allow the bank or its regulators to audit the third party as necessary or to receive reports, policies, or other documents as may be necessary to evaluate the third party's compliance. Each contract should also address the third party's requirement to comply with all applicable laws, regulations and guidance from regulators.

Products and Services

All products and/or services offered to bank customers must provide a definite benefit to the customer, especially when there is an out-of-pocket cost for the customer. The bank should be comfortable with the details of all products and services offered, the enrollment and cancellation process for the customers, and all associated benefits. The enrollment and termination process should be easy to understand and accomplish. Terminations should occur upon the first attempt or request.

It is important for the bank to gain a true understanding of all fees associated with any products or services offered under a contract by a third party. Any fees that will be passed on to a customer must be fully disclosed. The word "free" should only be used in instances in which there is absolutely no chance that a customer could be charged a fee at any time and an account or service is truly free.

It is an important reminder that a UDAAP analysis and risk assessment should be performed prior to offering any new products or services. All marketing materials, disclosures and agreements should also be reviewed from a UDAAP perspective as well.

Other considerations

As you conduct third party risk assessments, we recommend that you consider the long-term consequences of the terms of each contract and the benefits and risks associated with each product being offered. Each product or service offered through a third party should match your bank's strategic plan and long term goals.

(Memrie Fortenberry)

HAPPY BIRTHDAY CFPB (OR NOT)

On July 21, 2013, the CFPB celebrated its second birthday. That was only a few short days after the confirmation of Richard Cordray to be the first Director of the CFPB. In many ways that agency had been in limbo, believe it or not, with only an Acting Assistant Director in charge. At that, the CFPB was able to successfully begin its compliance examination function for those banks bigger than $10 billion, and at the same time finalize regulations aimed at restructuring mortgage finance in the United States.

But many observers think that the CFPB has only begun to hit its stride. Upcoming are the combined TILA/RESPA disclosure forms set for release yet sometime this year. Final action on the use of mandatory arbitration agreements in consumer finance contracts is also expected, and the CFPB is expected to step up enforcement actions against automobile sales finance companies and banks that purchase their contracts.

Perhaps one of the most important issues we can expect the CFPB to focus on will be Fair Lending. The search for unintentional discrimination based on the disparate impact theory of discrimination will likely intensify and will be complicated by the unintended consequences of the Ability to Repay and Qualified Mortgage Rules.

Already we think we see the CFPB's attitude toward Fair Lending influencing the other federal bank regulatory agencies. Recent CRA and Fair Lending exams conducted by the FDIC, the OCC and the Federal Reserve have become more thorough and more difficult. Compliance and safety and soundness examinations will also be more onerous once the Ability to Repay and Qualified Mortgage Rules kick in on January 10, 2014.

And we still await new regulations that will require the reporting of HMDA-like data for small business loans, focusing on loans to female and minority customers – more data for Fair Lending analysis.

It was probably inevitable that we would reach this point, and in some ways it may be a good thing to have a fully functional CFPB. But we can rest assured now, this new regulator is here to stay. We will continue to track these fast moving developments for the members of both Bank Groups.

(Ed Wilmesherr)

MRCG QUARTERLY MEETING TO BE HELD ON AUGUST 15, 2013

The MRCG will hold its August Quarterly Meeting on August 15, 2013, at the Mississippi Sports Hall of Fame & Museum Conference Center, 1152 Lakeland Drive, Jackson, Mississippi. Registration will begin at 9:00 a.m. with the meeting to begin at 9:30 a.m..

During the August meeting, we will discuss recent amendments and clarifications to the ability to repay and qualified mortgage rules as well as Appendix Q, an outline of an ability to repay/qualified mortgage loan policy, mortgage loan originator compensation and recent issues arising from compliance examinations.

As always, the dress code for this occasion is casual, and lunch will be provided. We ask that you fax or e-mail your registration to Liz Crabtree no later than Friday, August 9, 2013 so that arrangements for lunch can be finalized. We look forward to seeing you there.

(Cliff Harrison)

MSRCG MEETING TO BE HELD ON AUGUST 27, 2013

The MSRCG will hold its August Quarterly Meeting on August 27, 2013, at The Racquet Club of Memphis in the Large Ballroom located at 5111 Sanderlin Avenue, Memphis, Tennessee. Registration will begin at 9:00 a.m. with the meeting to begin at 9:30 a.m.

During the August meeting, we will discuss recent amendments and clarifications to the ability to repay and qualified mortgage rules as well as Appendix Q, an outline of an ability to repay/qualified mortgage loan policy, mortgage loan originator compensation and recent issues arising from compliance examinations.

As always, the dress code for this occasion is casual, and lunch will be provided. We ask that you fax or e-mail your registration to Liz Crabtree no later than Thursday, August 22, 2013 so that arrangements for lunch can be finalized. We look forward to seeing you there.

(Cliff Harrison)

MRCG-MSRCG COMPLIANCE CALENDAR

07/06/12 – Increased CMPs for flood violations effective	07/18/13 - MRCG-MSRCG Joint Steering Committee Meeting
02/12/13 – MSRCG Quarterly Meeting	07/22/13 – Comment period on proposed amendments to mortgage rules under Reg. B, Reg. Z and Reg. X expires
02/21/13 – MRCG Quarterly Meeting	08/15/13 - MRCG Quarterly Meeting
03/26/13 – Reg. E requirement for posting fee notice on ATMs repealed.	08/27/13 - MSRCG Quarterly Meeting
03/28/13 Reg. Z amendment limiting first year fees on credit card account effective	09/19/13 – MRCG-MRSCG Joint Steering Committee Meeting
04/18/13 – MRCG-MSRCG Joint Steering Committee Meeting	10/28/13 – Reg. E Remittance transfer rule effective
05/03/13 – Comment period on proposed amendment to 2013 escrow rule expires	11/19/13 - MSRCG Annual Meeting
05/17/13 – Comment period on proposed CRA Q&A expires	11/21/13 - MRCG Quarterly Meeting
05/21/13 - MSRCG Quarterly Meeting	01/10/14 – Ability to repay, qualified mortgage, mortgage servicing, MLO compensation and qualifications, HOEPA high cost mortgage rules effective
05/23/13 - MRCG Quarterly Meeting	01/10/14 – Financing single premium credit insurance on mortgage loans effective
06/01/13 – Escrow accounts for higher-priced mortgages expands to 5 years	01/18/14 – HPML appraisal rule, Reg. B rule on delivery of copy of appraisal effective
06/01/13 – Mandatory arbitration on mortgage loans prohibited	07/06/14 – Escrows for flood insurance premiums required for $1B + institutions
07/01/13 – UCC Article 9 changes for individual debtors, trusts and estates effective	