Ability-to-Repay/Qualified Mortgage Legal Stress Test (ATR Stress Test)

Dechert LLP

The Challenges

Once the Consumer Financial Protection Bureau's (Bureau) Ability-to-Repay and Qualified Mortgage rules (together ATR Rules) become effective on January 10, 2014, the bargaining power between lender and borrower will be changed and their respective obligations and liabilities will be restructured. The ATR Rules introduce a federal suitability standard that may provide troubled borrowers with damage claims and an important shield in responding to a foreclosure action, which may encourage the restructuring of delinquent mortgages.

We are pleased to have assisted the American Bankers Association in producing its new Guide for its members entitled ***A Strategic Guide to the ATR/QM Rules***, which evaluates the legal, compliance and cost considerations that arise in handling these issues.

Unlike many prior federal actions in this area, the ATR Rules do not merely create new lender disclosure or procedural obligations. They create a fundamentally new paradigm for residential mortgage lending by creating three new categories of loans with very different legal treatments and business and risk implications for lenders. This will change the way that mortgage lending programs are evaluated, implemented and priced. Lenders will be confronted with questions that they will need to properly answer to develop the best record to respond to regulatory and private party challenges.

Other important rules will also take effect next January. The Bureau's ***2013 CFPB Dodd-Frank Mortgage Readiness Guide*** warns lenders that they must be ready to roll out lending products that are consistent with Regulation X & Z's new high-cost mortgage counseling and mortgage servicing rules; Regulation B & Z's rules regarding appraisals for higher priced mortgages; and Regulation Z's additional lender compensation rules.

Dechert is helping its clients analyze these new risks and confront the difficult regulatory and governance challenges posed by new residential mortgage rules, so they can maximize their ability to achieve compliance as well as take advantage of the market opportunities also being created.

Critical Questions for Lenders

- What QM and non-QM mortgage products can/should be offered?
- Will the secondary markets and other lenders accept them and what types of representations and warranties will they require?
- What are the legal risks and attendant costs that flow from each new mortgage product?
- What defenses are available to respond to challenges by borrowers, regulators and others?
- How does a lender create the best record to protect management and directors?
- How will the handling of these issues impact future consolidation plans and regulatory relationships?

Dechert's Bank Regulatory Team

Our bank regulatory team is led by two partners with many years of experience in bank regulatory and mortgage regulation areas.

Learn more at:
www.dechert.com/financial_institutions.

Thomas P. Vartanian is a former General Counsel of the Federal Home Loan Bank Board (FHLBB), and a former Assistant to the Chief Counsel of the Comptroller of the Currency. He has advised clients regarding mortgage related issues for more than 30 years.

Learn more at:
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Robert H. Ledig is a former regulatory policy attorney at the FHLBB. He advises financial institutions on corporate, regulatory and enforcement and litigation matters. He was the editor and co-author of Dechert's *Analysis of the Dodd-Frank Act for the American Bankers Association*.

Learn more at:
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The Big Five Risks

As lenders begin to determine the kinds of mortgage products that they will offer, they will find themselves wedged between five risks:

- Compliance with the requirements of the ATR Rules
- Increased chances of a challenge by the government or third parties under evolving fair lending laws
- An increased risk of non-repayment on mortgage loans
- A potential diminishment in the value and liquidity of the mortgage portfolio
- Evolving standards and requirements of the secondary market and collateral lenders

The Role of the Secondary Mortgage Market

Mortgage liquidity, transferability and securitization dynamics will also impact how lenders choose the mortgage products they offer. Given the state of the secondary mortgage market, which is currently dominated by Fannie Mae and Freddie Mac, both of which are in federal conservatorship, this will be an evolving impact. However, if secondary markets determine they only want QM Loans, this will likely be the product that lenders will most frequently offer. In that regard, the Federal Housing Finance Agency has already directed Fannie Mae and Freddie Mac to purchase only loans that generally meet QM Loan requirements. The standards that Federal Home Loan Banks adopt with regard to their collateral requirements for advances and their mortgage purchase programs will also influence the post-ATR Rules development of the mortgage origination market.

Lenders need to keep their fingers on the legal pulse of these developments in order to determine the mortgage lending program that best fits their goals.

Fair Lending Risks

Where lenders refocus their business on making only QM Loans, for example, there is the potential that this will have an adverse impact on the availability of mortgage credit to protected groups. This may trigger investigations or challenges by governmental or private parties on a theory of disparate impact discrimination under the Fair Housing Act and the Equal Credit Opportunity Act. Under disparate impact theory, once a disproportionate adverse impact is shown the burden shifts to a lender to provide a business justification for a facially neutral policy.

The increased exposure to fair lending challenges requires lenders to evaluate the risk, costs and reputational downside of running into problems in this area. For example, in addition to obvious impacts, problems in this area are likely to impact an institution's ability to engage in acquisitions or to be acquired.

Dechert's Residential Mortgage Finance Team

In addition to our Banking Team, we have an experienced group that handles residential mortgage loan sales and securitizations.

Learn more at:
www.dechert.com/structured_finance.

Ralph R. Mazzeo focuses on mortgage finance and capital markets, with a particular emphasis on structured finance, including residential mortgage-backed securities.

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www.dechert.com/ralph_mazzeo.

Dechert's Fair Lending Team

Thomas P. Vartanian and Robert H. Ledig are co-authors of the treatise ***The Fair Lending Guide***, which became a leading work in the area of fair lending liability under disparate treatment and disparate impact theories, and government and private sector challenges to lenders.

Together, they have handled a number of significant fair lending challenges against a variety of lenders.

For up-to-date information on the QM/ATR Rules and other Dodd-Frank analysis, please visit our Financial Services Reform site at **www.dechert.com/FS-Reform**.

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The ATR-QM Legal Stress Test (ATR Stress Test)

As new mortgage products and compliance programs are developed, institutions should legally evaluate the risks inherent in new lending policies and compliance programs from the perspective of the Big Five Risks if there is to be a reasonable and defensible correlation between products, programs and costs.

Dechert is advising its clients to carefully evaluate these risks and treat them consistent with others in a manner that reflects proper corporate governance, adequate documentation, risk mitigation and maintenance of a safe and sound banking operation. Indeed, the Bureau's Readiness Guide specifically asks whether directors of the company have been properly advised and have reviewed new programs and risks.

We believe that lenders who are in the process of developing or implementing their response to the ATR Rules can benefit from our ATR Legal Stress Test. It will assist lenders and their financial advisors to:

- Understand the legal challenges that may be brought and the potential exposures of officers and directors
- Develop a solid corporate record upon which business decisions may be made that regulators can evaluate
- Present the appropriate options and risk analyses to executive officers and/or boards of directors
- Reach a reasonable level of comfort regarding the extent to which programs, policies and pricing achieve their business and legal goals and anticipate, and deflect administrative challenges and litigation by regulators or private parties

Dechert will work with clients to tailor assistance to the particular needs and circumstances of a client. This may involve, among other things, providing assistance to management or working with management, external financial advisors and consultants, and providing advice to an institution's board of directors.

Our ATR Legal Stress Test product consists of five critical elements:

1. Identification of the range of legal challenges that can be brought by regulators, private parties and other governmental authorities based on the mortgage products, programs and execution policies (Final Product) chosen and implemented by the lender.
2. Cataloguing of available defenses to claims that may be asserted by regulators, private parties including borrowers, and other governmental authorities, and the potential exposures if such defenses are not successful.
3. Recommending Final Product modifications to strengthen defenses against potential legal challenges identified in #1.
4. Recommending Final Product modifications to increase conformity with and acceptance by secondary market, providers of wholesale funding secured by residential mortgage loans and other private parties.
5. Written and oral presentations to management and/or the board of directors regarding the legal risks inherent in the company's mortgage programs, memorializing the results of points 1–4 above.

Costs

Costs for our ATR Stress Test are based on the nature and scope of the assistance that a client decides it would like us to provide. We offer innovative fee agreements that are responsive to client needs and preferences, including flat fees based on the size of the organization.