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CFPB Finalizes Ability-to-Repay and Qualified Mortgage Rule

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In this article, the authors analyze new regulations issued by the Consumer Financial Protection Bureau that require a creditor to determine, for all consumer credit transactions secured by a dwelling, whether the consumer has the ability to repay the loan, and that define qualified mortgages, for which creditors are presumed to have complied with the ability-to-repay rule.

Earlier this year, the Consumer Financial Protection Bureau ("CFPB") issued its final ability-to-repay and qualified mortgage rule, amending Regulation Z and implementing Sections 1411 and 1412 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").[1] Sections 1411 and 1412 require lenders to assess consumers' ability to repay home loans before extending credit and provide a safe harbor and a presumption of compliance with the ability-to-repay requirement for so-called "qualified mortgages." The CFPB subsequently issued an additional final rule on May 29, 2013, which amended the ability-to-repay and qualified mortgage standards (the "May 2013 Amendments"). Both final rules become effective January 10, 2014.[2]

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OVERVIEW

The intent of the final rule is to ensure that creditors give appropriate consideration to consumers' ability to repay home loans when making lending decisions, and to strengthen the underwriting practices in the credit industry that are often cited as a cause of the recent recession. Thus, the final rule focuses on establishing factors for ability-to-repay determinations and uniform baselines for underwriting standards.[3]

Currently, Regulation Z, as amended by the Board of Governors of the Federal Reserve System in 2008, prohibits creditors from extending higher-priced mortgage loans without regard for the consumer's ability to repay. The final rule extends application of this requirement to all loans secured by dwellings, not just higher-priced mortgages. Creditors must, at a minimum, consider eight factors while making a determination that the consumer has a reasonable ability to repay the loan before entering any consumer credit transaction secured by virtually any dwelling.[4] The factors include information such as the consumer's income, debt obligations, credit history, and monthly payments on the loan. Additionally, the final rule establishes a safe harbor and a presumption of compliance with the ability-to-repay requirement for so-called "qualified mortgages," restricts application of prepayment penalties, and requires retention of evidence of compliance with the ability-to-repay requirement for three years.[5]

ANALYSIS

The final rule adds Section 1026.43 to Regulation Z.[6] Section 1026.43 applies to any consumer credit transaction secured by a dwelling ("covered transaction"), including all residential mortgage loans such as home purchase, refinancing, home equity, first lien, and subordinate loans. "Dwelling" encompasses principal residences, second homes, vacation homes, one-to four-unit residences, condominiums, cooperatives, mobile homes, and manufactured homes. Section 1026.43 does not apply, however, if the loan is for a business, commercial, or agriculture purpose, even if secured by a dwelling. Open-end lines of credit, covered by Section 1026.40, are specifically excluded from Section 1026.43.

The Ability-to-Repay Requirement

Before extending a loan covered by Section 1026.43, a creditor must make 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."[7] The determination depends on the facts and circumstances that the creditor knows or should have known at the time of consummation. Indicators of a reasonable and good faith determination include the consumer's timely repayment, the use of underwriting standards that historically result in low default rates, and use of underwriting standards based on demonstrably sound models. Conversely, defaults shortly after consummation, inconsistent use of underwriting standards, use of standards ineffective at determining repayment ability, and insufficient residual income all suggest the determination was not reasonable or in good faith.

When making the ability-to-repay determination, creditors must use third-party records to verify all information on which they rely, and consider at least the following eight factors:

- The consumer's current or reasonably expected income or assets, other than those used to secure the loan;
- The consumer's current employment status, if "income" is used as a basis for determination;
- The consumer's expected monthly payment on the covered transaction;
- The consumer's monthly payment on any simultaneous loans;
- The consumer's monthly payment of mortgage-related obligations;
- The consumer's current debt obligations, alimony, and child support;
- The consumer's debt-to-income ratio or residual income; and
- The consumer's credit history.

When evaluating these eight factors, creditors may rely on their own definitions and underwriting standards except for the underwriting standards the rule provides for calculating monthly payments on the loan and debt-to-income ratios. The final rule provides that, when calculating the monthly payment under factor (iii), creditors must use the greater of the fully indexed rate or any introductory rate, and substantially equal, fully amortizing monthly payments. Loans with balloon payments, interest-only loans, and negative amortization loans require similar calculations. The "fully indexed rate" is the rate that will apply after the loan "recasts," which is the expiration of any introductory, interest-only, or negative amortization payment period. The result of this provision is to require creditors to consider whether or not a consumer will be able to make payments if the highest possible rate applies throughout the life of the loan.

With respect to factor (vii), creditors must calculate a consumer's debt-to-income ratio using the consumer's total monthly debt obligations and total monthly income. "Total debt obligations" is the sum of payments on the loan, simultaneous loans, mortgage-related obligations, current debt obligations, alimony, and child support. "Total monthly income" is the sum of current and "reasonably expected" income, and can include income from assets. The creditor, however, can determine the appropriate ratio that will support a reasonable determination of a consumer's ability to repay.

The final rule requires creditors to retain evidence of compliance with the ability-to-repay requirement for three years.

Exemption from the Ability-to-Repay Requirement: Refinancing Non-standard Mortgages

To encourage refinancing of certain mortgages, the final rule exempts from the ability-to-repay requirement the refinancing of non-standard mortgages into standard mortgages. The rule targets three non-standard loans: adjustable-rate loans, interest-only loans, and negative amortization loans. In order for the exemption to apply, creditors must consider whether the consumer is likely to default when the existing loan is recast, and whether refinancing will likely prevent the default. If so, the exemption applies as long as the following conditions are met:

(i) the creditor is the current holder of the non-standard mortgage;

(ii) the standard mortgage monthly payment will be materially lower than the non-standard mortgage payment;

(iii) the creditor receives the consumer's written application no later than two months after the nonstandard mortgage recast;

(iv) the consumer did not make more than one payment more than 30 days late during the preceding twelve months of receipt of the application;

(v) the consumer did not make any payment more than 30 days late during the preceding six months of receipt of the application; and

(vi) if the non-standard mortgage was consummated on or after January 10, 2014, it was made in accordance with the ability-to-repay requirement.

Whether or not a new standard mortgage payment meets the "materially lower" standard of factor (ii) depends on the facts and circumstances surrounding the loan. However, the CFPB's official interpretations of the final rule provide that any refinancing that results in a 10 percent payment reduction will satisfy the materially lower standard. The final rule prescribes methods for calculating payments in order to facilitate comparison of the non-standard and standard payments. The methods are similar to those under the ability-to-repay requirement in that they establish a substantially equal monthly payment using the fully indexed rate under the terms of the loan.

Qualified Mortgages

The final rule establishes a safe harbor and a presumption of compliance with the ability-to-repay requirement for certain qualifying loans. If a covered transaction satisfies the requirements of a qualified mortgage, outlined below, and *is not* a higher-priced mortgage,[8] then the creditor is deemed to have complied with the ability-to-repay requirement and is entitled to the safe harbor provided by Section 1026.43(e) of Regulation Z.

Alternatively, if the covered transaction satisfies the requirements of a qualified mortgage and *is* a higher-priced mortgage, then there is a rebuttable presumption that the creditor complied with the ability-to-repay requirement. This presumption is overcome when the consumer proves that despite meeting the requirements of the definition of qualified mortgage, the creditor did not make a reasonable and good faith determination of the consumer's ability to repay. The consumer must show that his debt obligations, alimony, child support, and monthly payments on the covered transaction and simultaneous loans would leave him with insufficient income to meet living expenses. However, the longer a consumer continues to pay after the loan recasts, the more likely it is the creditor made a reasonable and good faith determination. Consumers will encounter this presumption when bringing actions seeking special statutory damages for violation of the ability-to-repay requirement, and when raising violation of the ability-to-repay requirement as a defense in foreclosure actions.

The Dodd-Frank Act specified minimum requirements for a qualified mortgage, and gave the CFPB discretion to supplement those requirements as it saw fit. A qualified mortgage is a credit transaction secured by a dwelling:

(i) that provides for regular, periodic, and substantially equal payments that do not result in an increased principal balance, allow consumer to defer repayment of principal, or result in balloon payment;

(ii) that does not exceed 30 years;

(iii) that does not have points and fees exceeding a specified cap;

(iv) where the creditor underwrites using the maximum interest rate applicable during the first five years of the loan, and payments that will repay the loan within the term of the loan;

(v) where the creditor considers and verifies a consumer's reasonably expected income or assets, debt obligations, alimony, and child support in accordance with Appendix Q to Regulation Z; and

(vi) where the consumer's debt-to-income ratio does not exceed 43 percent, as determined under Appendix Q.

Notably, these requirements are similar to the ability-to-repay factors but establish a higher threshold of compliance to justify both the safe harbor and presumption of compliance provisions. Essentially, creditors must meet a higher underwriting standard for qualified mortgages than those needed to satisfy the ability-to-repay requirement.

The definition of qualified mortgage requires a specific debt-to-income ratio, a limit on the term of the loan, and a cap on the points and fees assessed. Qualified mortgages also exclude negative amortization loans, interest-only loans, and non-rural balloon-payment loans.[9] If one or more payments are applied solely to interest, then the payment counts as a deferment and thus disqualifies the loan. Lastly, for requirements (v) and (vi), Appendix Q to Regulation Z contains a detailed list of additional requirements for qualified mortgages that are unnecessary to meet the ability-to-pay requirement. For example, Appendix Q requires the creditor to verify employment from the previous two years, as well as to assess the likelihood of employment continuing for the first three years of the loan.

Concerned with the possible initial reluctance of creditors to extend loans that are not qualified mortgages, the final rule includes a temporary alternate definition of qualified mortgages with a more flexible underwriting requirement. Under this temporary definition, transactions are qualified mortgages if they meet the first three requirements listed above, and are at least one of the following:

- eligible for purchase by Fannie Mae or Freddie Mac;
- eligible to be insured by the U.S. Department of Housing and Urban Development;
- eligible to be guaranteed by U.S. Department of Veterans Affairs;
- eligible to be guaranteed by the U.S. Department of Agriculture; or
- eligible to be insured by the Rural Housing Service.

Importantly, the named departments and agencies need not actually purchase, guarantee, or insure the loans. Nor does the creditor actually need to sell the loan. The loans must simply be eligible. The temporary definition expires on the effective date of a rule issued by the named agencies which redefines "qualified mortgage," or on January 10, 2021.

Other Provisions

The final rule permits a narrow and restrictive use of prepayment penalties. Covered transactions cannot include a prepayment penalty unless otherwise permitted by law and the loan has an annual percentage rate that cannot increase, is a qualified mortgage, and is not a higher-priced mortgage. The penalty must not apply after three years following consummation and must not exceed a listed percentage of the outstanding balance. Additionally, if a creditor offers a loan containing a prepayment penalty, it must also offer an alternative loan without a penalty and have a good faith belief that the consumer is likely to qualify for the alternative. This restriction on prepayment penalties does not apply if the loan is not a covered transaction.

The final rule also contains an evasion provision. The provision states that a creditor cannot structure a loan as an open-end plan in order to avoid the requirements of Section 1026.43 when the credit is secured by a consumer's dwelling.

MAY 2013 AMENDMENTS

The May 2013 Amendments to the ability-to-repay and qualified mortgage standards exempt certain transactions from the ability-to-repay standard. Credit extended pursuant to a Housing Finance Agency program or a program authorized by sections 101 and 109 of the Emergency Economic Stabilization Act of 2008, and loans made by a Community Development Financial Institution, a Downpayment Assistance Provider of Secondary Financing, or a Community Development Organization are not subject to the ability-to-repay standard.

The May 2013 Amendments also create an additional definition of qualified mortgage that applies to small creditors if the creditor keeps the mortgage in its portfolio for at least three years.[10] Under this definition, a qualified mortgage is a credit transaction:

- that provides for regular, periodic, and substantially equal payments that do not result in an increased principal balance, allow a consumer to defer repayment of principal, or result in a balloon payment;
- that does not exceed 30 years;
- that does not have points and fees exceeding a specified cap;
- in which the creditor underwrites using the maximum interest rate applicable during the first five years of the loan, and payments that will repay the loan within the term of the loan;

- in which the creditor considers and verifies the consumer's reasonably expected income or assets and debt-to-income ratio in accordance with the ability-to-repay standard; and
- in which the creditor considers and verifies the consumer's debt obligations, alimony, and child support in accordance with the qualified mortgage standard.

Importantly, small creditors are subject to neither the specific 43 percent debt-to-income ratio, nor the higher threshold of Appendix Q to Regulation Z. Small creditors may also, under the May 2013 Amendments temporarily extend qualified mortgages that contain balloon payments. All such mortgages must be consummated on or before January 10, 2016.

Additionally, the May 2013 Amendments exclude loan originator compensation under certain circumstances from the definition of points and fees in order to avoid double counting. Originally, the definition of points and fees could include loan originator compensation under finance charges as well as under compensation paid by a consumer or creditor to a loan originator. The amendments add a qualifier that excludes compensation paid by a consumer or creditor to a loan originator from the definition of points and fees if such compensation was already included under finance charges.

CONCLUSION

Under the new regulations, for all consumer credit transactions secured by a dwelling, a creditor must determine that the consumer has the ability to repay the loan. The creditor must base its determination on at least the eight prescribed factors using information verified by third-party records. If the creditor satisfies the higher threshold required for qualified mortgages, the creditor will be deemed to have complied with the ability-to-repay requirement, unless it is a "higher-priced mortgage loan," in which case there is a rebuttable presumption that the creditor complied with the ability-to-repay requirement. Although negative amortization, interest-only, and non-rural balloon payment loans cannot be qualified mortgages, creditors may still offer these products as long as they satisfy the ability-to-repay requirement.

NOTES

[1] Ability-to-Repay and Qualified Mortgage Standards Under the Truth-in-Lending Act, Final Rule, 78 Fed. Reg. 6408 (Jan. 30, 2013) (to be codified at 12 C.F.R. Part 1026).

[2] We note that a recent decision by the D.C. Circuit Court of Appeals has raised questions regarding the constitutionality of the president's recess appointment of Richard Cordray as director of the CFPB. If his appointment were successfully challenged, certain rules issued during his tenure, including this qualified mortgage rule, could potentially be invalidated. Although a number of intervening events could avert such a result, the Dodd-Frank Act provides that the statutory qualitative mortgage provisions become effective as of January 21, 2013 in the absence of a rulemaking. As such, the qualitative mortgage provisions of the Dodd-Frank Act would become immediately effective if the final rule were to be invalidated.

[3] Contrary to a widely held misconception among industry observers, the final rule does not prohibit creditors from extending adjustable-rate loans, interest-only loans, and negative amortization loans. However, with limited exceptions, adjustable rate loans that result in an increase in principal balance, allow the consumer to defer repayment of principal, or result in balloon payments cannot be qualified mortgages.

[4] 12 C.F.R. § 1026.43(c)(1).

[5] We note that a "qualified mortgage" should not be confused with the related but distinct concept of a "qualified residential mortgage." The term "qualified residential mortgage" ("QRM") relates to the credit risk retention requirements introduced by Section 941(b) of the Dodd-Frank Act, which generally require the securitizer of asset-backed securities ("ABS") to retain at least five percent of the credit risk of the assets collateralizing the ABS. This requirement does not apply, however, if all of the assets that collateralized the ABS are QRMs. The Dodd-Frank Act links the concepts of QRMs and qualified mortgages by providing that the definition of QRM may be "no broader than" the definition of qualified mortgages. The CFPB and other agencies proposed a definition for "QRM" in a separate rulemaking issued on April 29, 2011, which has remained in proposed form pending the finalization of the definition of a "qualified mortgage."

[6] 12 C.F.R. § 1026.43.

[7] 12 C.F.R. § 1026.43(c)(1).

[8] Higher-priced mortgages have an annual rate exceeding the average prime offer rate by 1.5 percentage points or more for a first-lien transaction that is not a qualified mortgage by a small creditor, by 3.5 percentage points or more for a first-lien transaction that is a qualified mortgage by a small creditor, or by 3.5 percentage points or more for subordinate-lien covered transactions.

[9] Loans that include a balloon payment may still be a qualified mortgage if the loan satisfies applicable parts of the definition of qualified mortgage, the creditor determines the consumer can make all scheduled payments under legal obligation, the creditor operates in predominantly rural or underserved areas, and the loan is not subject to a commitment to be acquired by a non-rural creditor. If sold, assigned, or otherwise transferred, the loan will lose its qualified status unless certain specified conditions apply.

[10] Small creditors are defined as creditors with less than $2 billion in assets and that originate no more than 500 first-lien mortgages per year. 12 C.F.R. § 1026.43(e)(5)(i)(D).