



New Qualified Mortgage Rules Released by the Consumer Finance Protection Bureau

January 2013

I. Introduction

Few would dispute that the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act or Act) has fundamentally altered the residential mortgage industry. Although the Act was passed just over three years ago, one of the most significant decisions regarding the full impact of the Dodd-Frank Act came when the Bureau of Consumer Financial Protection (CFPB) announced its final Ability-to-Repay rule on January 10, 2013. The CFPB had long been considering two alternative definitions to the term “qualified mortgage.” The disparate alternatives to the ambiguity created by the Dodd-Frank Act presented enormous implications on the ability of creditors to remain in the mortgage lending industry as well as the ability of consumers to secure affordable mortgage products. This article will discuss the final rule issued by the CFPB.

II. The Ambiguity Created by Dodd-Frank

The Dodd-Frank Act, which amended the Truth in Lending Act (TILA), prohibits a creditor from originating a residential mortgage loan without considering the ability of the consumer to repay the loan.¹ Unfortunately, the Dodd-Frank Act’s clarity on this requirement seems to end there. The Dodd-Frank Act allows creditors to originate a “qualified mortgage,” but the language of the statute reveals an ambiguity as to whether Congress intended such a “qualified mortgage” to constitute a legal safe harbor under the ability-to-repay requirement or a rebuttable presumption of compliance.² In fact, the relevant section heading under the Dodd-Frank Act is titled “Safe Harbor and Rebuttable Presumption.”³

The agency assigned with the task of resolving this ambiguity was the CFPB. However, the Dodd-Frank Act originally delegated the task to the Board of Governors of the Federal Reserve System (Board).⁴ The Act granted the Board the authority to “prescribe regulations that revise, add to, or

¹ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1411, 124 Stat. 1376, 2142-45 (2010) (to be codified at 15 U.S.C. §1639c).

² *Id.* at § 1412.

³ *Id.*

⁴ *Id.*

subtract from the criteria that define a qualified mortgage upon a finding that such regulations are necessary or proper to ensure that responsible, affordable mortgage credit remains available to consumers” for the purpose of carrying out the ability to repay requirement.⁵ The Board’s proposed rule to amend Regulation Z under TILA required creditors to determine a consumer’s ability to repay a mortgage before making the loan and establish minimum mortgage underwriting standards.⁶ Truly reflecting the statutory ambiguity under the Dodd-Frank Act, the Board also offered for public comment the two alternative definitions of “qualified mortgage” as a part of that proposed regulation—the safe harbor alternative and the rebuttable presumption alternative.⁷

As of July 21, 2011, general rulemaking authority for TILA has passed from the Board to the CFPB, leaving the CFPB with the responsibility for making the ultimate decision on the final rule.⁸

III. The Ability to Repay Requirement

Under the Dodd-Frank Act, there are two ways to satisfy the ability to repay requirement. The Act provides that “[a]ny creditor with respect to any residential mortgage loan, and any assignee of such loan subject to liability under this title, may presume that the loan has met the [ability-to-repay requirement], if the loan is a qualified mortgage.”⁹ Thus, one can comply with the ability to repay standard or issue a qualified mortgage. The ability to repay standard is met first by considering and verifying eight underwriting factors and then by underwriting the payment for an adjustable-rate mortgage based on the fully indexed rate. The eight underwriting factors include: (1) income or assets relied upon in making the ability-to-repay determination; (2) current employment status; (3) the monthly payment on the mortgage; (4) the monthly payment on any simultaneous mortgage; (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.¹⁰

While the ability-to-repay standard was more clearly presented in the Dodd-Frank Act, as explained above, the prospect of utilizing the “qualified mortgage” option remained unclear until the CFPB’s recent action. In order to understand the significance of the CFPB’s final rule, a brief look at the Board’s proposed rules is instructive.

⁵ *Id.*

⁶ See Regulation Z; Truth in Lending, 76 Fed. Reg. 27,389, 27,394 (proposed May 11, 2011) (to be codified at 12 C.F.R. pt. 226).

⁷ *Id.* at 27,501.

⁸ Dodd-Frank Act §§ 1061-62.

⁹ *Id.* § 1412.

¹⁰ *Id.* § 1411.

A. Qualified Mortgage

Under the Board's proposed ability to repay rules, there was a clear distinction between the alternatives of a legal safe harbor and a rebuttable presumption of compliance. However, the final rule issued by the CFPB drew middle line.

1. The Board's Alternatives

Consistent with the definition provided in the Dodd-Frank Act itself,¹¹ under the Board's legal safe harbor definition, a "qualified mortgage" was a mortgage for which:

- The loan does not contain negative amortization, interest-only payments, or balloon payments;
- The term does not exceed 30 years;
- The total points and fees generally do not exceed three percent of the total loan amount;
- The income or assets are considered and verified; and
- The underwriting: (1) Is based on the maximum rate during the first five years, (2) uses a payment scheduled that fully amortizes the loan over the loan term, and (3) takes into account any mortgage-related obligations.¹²

The safe harbor excused creditors from having to undertake a number of the underwriting factors presented in the general ability-to-repay requirements. A creditor would not have been required to consider or verify the consumer's employment status, the payment of any simultaneous loans of which the creditor knows or has reason to know, the consumer's current obligations, and the consumer's credit history.¹³ Simply by satisfying the safe harbor requirements, a creditor was excused from the performance of the excluded underwriting factors listed under the general ability-to-repay standard.

The alternative to the safe harbor was the rebuttable presumption of compliance standard. The rebuttable presumption standard incorporated the same factors used in the safe harbor alternative but also added the additional underwriting requirements from the general ability-to-repay standard. Thus, under this alternative, the creditor would have had to consider and verify:

- The consumer's employment status,
- The monthly payment for any simultaneous mortgage,
- The consumer's current debt obligations,

¹¹ See *id.* While the safe harbor alternative largely follows the statutory definition, it does not include the requirement that the creditor consider the consumer's debt-to-income ratio or residual income.

¹² Regulation Z; Truth in Lending, 76 Fed. Reg. at 27,501.

¹³ *Id.*

- The monthly debt-to-income ratio or residual income, and
- The consumer's credit history.¹⁴

The imposition of the rebuttable presumption of compliance would have required creditors to make individualized determinations that the consumer had the ability to repay the loan based on all of the underwriting factors listed under the general ability-to-repay standard. Moreover, compliance with the criteria would not have staved off attempts by a consumer to argue that a creditor did not make a reasonable and good faith determination of their ability to repay the loan at issue.

2. The Final Rule

The final Ability-to-Repay rule went in a different direction than the Board's all-or-nothing proposals. In effect, the CFPB created one standard for defining "qualified mortgage" but then created two types, one providing a safe harbor and the other leaving lenders with the rebuttable presumption standard.

The CFPB borrowed heavily from the Board's safe harbor proposal in outlining the features of a "qualified mortgage." Under the CFPB's final rule, a qualified mortgage would have the following features:

- **No excess upfront points and fees**¹⁵
- **No toxic loan features:**
 - No interest-only loans;¹⁶
 - No loans where the principal amount increases, such as negative-amortization loans;¹⁷ and
 - No loans where the term is longer than 30 years.¹⁸
- **Cap on how much income can go toward debt:**¹⁹
 - Qualified Mortgages generally will be provided to people who have debt-to-income ratios less than or equal to 43 percent. For a temporary, transitional period, loans that do not have a 43 percent debt-to-income ratio but meet government affordability or other standards – such as that they are eligible for purchase by the Federal National Mortgage Association (Fannie Mae) or the Federal Home Loan Mortgage Corporation (Freddie Mac) – will be considered Qualified Mortgages.

¹⁴ *Id.*

¹⁵ For limits on points and fees for qualified mortgages see Ability-to-Repay and Qualified Mortgage Standards under the Truth in Lending Act, 12 C.F.R. § 1026.43(e)(3).

¹⁶ § 1026.43(e)(2)(i)(B).

¹⁷ § 1026.43(e)(2)(i)(A).

¹⁸ § 1026.43(e)(2)(ii).

¹⁹ § 1026.43(e)(2)(vi).

- **No loans with a balloon payment except those made by smaller creditors in rural or underserved areas.**²⁰

As noted, the “qualified mortgage” definition is quite close to the Board’s proposed safe harbor alternative. However, compliance with the qualified mortgage features does not assure a creditor of a safe harbor. Instead, the CFPB created a bright line rule, which splits qualified mortgages into two camps. First, there are “higher-priced” mortgage loans, which are defined as having an APR that exceeds APOR by 1.5 percentage points for first liens and 3.5 percentage points for second liens.²¹ These “higher-priced” loans receive only a rebuttable presumption of compliance.²² Thus, even a mortgage loan meeting all of the requirements of a “qualified mortgage” could still be challenged by a consumer alleging that the creditor did not make a reasonable and good faith determination of the consumer’s repayment ability at the time of consummation. Next, there are “lower-priced” mortgage loans, which, predictably, fall below the standards mentioned above. “Lower-priced” mortgage loans qualify for the legal safe harbor and cannot be legally challenged.²³

IV. Evaluating the Decision

The differences between the Board’s two proposals were plainly apparent. The legal safe harbor effectively created an incentive to make qualified mortgages while the rebuttable presumption all but made the concept of having a qualified mortgage superfluous. The mortgage industry pushed hard for the purely safe harbor standard, and consumer groups sought an across-the-board rebuttable presumption. It is no wonder that the CFPB effectively split the difference in its new rule.

The final rule provides protections to consumers while still providing clarity to creditors about the applicable standards for invoking the protections of the safe harbor. If nothing else, the CFPB is to be applauded for providing well-defined standards, such as the 43 percent debt-to-income ratio and the safe harbor/rebuttable presumption distinction between prime and subprime mortgage loans. There will undoubtedly be parties from the mortgage lending and the consumer protection sides of this issue that will be upset with where the CFPB drew the line, but this outcome is clearly a step up from the alternatives presented by the Board. Richard Cordray, Director of the CFPB, adequately summarizes the rule: “No standard is perfect, but this standard draws a clear line that will provide a real measure of protection to borrowers and increased certainty to the mortgage market.”²⁴

²⁰ § 1026.43(f).

²¹ § 1026.43(b)(4).

²² § 1026.43(e)(1)(ii).

²³ § 1026.43 (e)(1)(i).

²⁴ Prepared Remarks of Richard Cordray at the Ability-to-Repay Rule Field Hearing (Jan. 10, 2013), *available at* <http://www.consumerfinance.gov/speeches/prepared-remarks-of-richard-cordray-at-the-ability-to-pay-rule-field-hearing/>.

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