Lenders Compliance Group

Thursday, January 10, 2013

CFPB's Final Rule: Ability-to-Repay and Qualified Mortgages

Yesterday, I provided an outline of the Consumer Financial Protection Bureau's (CFPB's) Regulatory Agenda for 2013. As if on cue, the CFPB has accommodated us today with the first of its forthcoming issuances.* This pertains to the Final Rule regarding Ability-to-Repay, which leaves the Final Rule issuances this month for Loan Originator Compensation, Mortgage Servicing, and Requirements for Escrow Accounts.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) required that, for residential mortgages, creditors must make a reasonable and good faith determination based on verified and documented information that the consumer has a reasonable ability to repay the loan according to its terms. It also established a "presumption" of compliance for a certain category of mortgages, which was called "qualified mortgages" or "QMs." These provisions are similar, but not identical to, the Federal Reserve Board's (FRB's) 2008 rule and cover the entire mortgage market rather than simply higher-priced mortgages. The FRB proposed a rule to implement the new statutory requirements before authority passed to the CFPB to finalize the rule.

I have written extensively about Ability-to-Repay and the Qualified Mortgage.

Please feel free to review these articles.

In this article, I would like to mention the premises used as the reasons for an Ability-to-Repay rule (ATR). Then I will outline the essential features of ATR, followed by a review of the "Qualified Mortgage." Finally, I will provide a general summation in order to provide some context with respect to the Final Rule's implementation.

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Premises for Ability-to-Repay

The CFPB believes that when consumers apply for a mortgage they "often struggle to understand how much of a monthly payment they can afford to take on." Thus, according to the CFPB, the consumer may reasonably assume that lenders and mortgage brokers would not make loans to people who cannot afford them. But in the years leading up to the financial crisis, the CFPB asserts that lenders too often made mortgages that could not be paid back.

Therefore, the purpose of ATR is to require lenders to obtain and verify information to determine whether a consumer can afford to repay the mortgage and, per the CFPB, thereby help to restore trust in the mortgage market.

These are the premises upon which the CFPB has established the need for Ability-to-Repay:

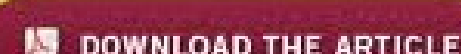
-In the lead up to the financial crisis, certain lending practices set consumers up to fail with mortgages they could not afford.

-The deterioration in underwriting standards contributed to dramatic increases in mortgage delinquencies and rates of foreclosures.

-The Dodd-Frank Act recognizes the need to mandate that lenders ensure consumers have the ability to pay back their mortgages.

-The Ability-to-Repay rule protects consumers from risky practices that helped cause the crisis.

In its review of the above-mentioned premises, the CFPB had taken the position that lenders sold no-doc and low-doc loans where consumers were "qualifying" for loans beyond their means. Lenders also "sold risky and complicated mortgages like interest-only loans, negative-amortization loans where the principal and eventually the monthly payment increases, hybrid adjustable-rate mortgages where the rate was set artificially low for years and then adjusted upwards, and option adjustable-rate mortgages where the consumer could "pick a payment" which might result in negative amortization and eventually higher monthly payments."



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which might result in negative amortization and eventually higher monthly payments.

In plain English, the CFPB asserts that lenders should not be able to offer no-doc, low-doc loans, otherwise known as "Alt-A" loans, where some lenders made quick sales by not requiring specific, qualifying documentation, yet then offloaded these risky mortgages by selling them to investors.

As it was contended, these actions precipitated the collapse of the housing market in 2008 and the subsequent financial crisis.

Dodd-Frank provides the authority to the CFPB to define criteria for certain loans called "Qualified Mortgages" that are presumed to meet the Ability-to-Repay rule requirements.

The salient observation about ATR is that the CFPB is issuing this rule in order "to ensure that responsible consumers get responsible loans," as well as ensuring that "lenders can extend credit responsibly - without worrying about competition from unscrupulous lenders."

What is Ability-to-Repay?

There are four (4) ATR components, each in its own way requiring the lender to obtain financial information from the loan applicant and verify them.

Component 1: Underwriting Standards

The procedure must follow, at a minimum, eight (8) specific underwriting standards:

1. Current income or assets;
2. Current employment status;
3. Credit history;
4. The monthly payment for the mortgage;
5. The monthly payments on any other loans associated with the property;
6. The monthly payment for other mortgage related obligations (i.e., property taxes);
7. Other debt obligations; and
8. The monthly debt-to-income ratio or residual income the borrower would be taking on with the mortgage.

Component 2: Sufficient Assets or Income

The borrower must have "sufficient assets or income" to pay back the mortgage. Lender are charged with the duty to determine whether a borrower can repay the loan, by means of looking at the borrower's income and any assets.

Component 3: Qualifying without Teaser Rates

So-called "teaser rates" can "no longer mask" the true cost of a mortgage. This means that the lender cannot evaluate a consumer's ability to repay the loan based on a teaser rate. Put otherwise, lenders will have to determine the consumer's ability to repay both the principal and the interest "over the long term."

Component 4: Risky Loan Exemption

If a consumer wants to refinance a risky loan - such as an adjustable-rate mortgage, an interest-only loan, or a negative-amortization loan - an exemption applies whereby such a refinance is permitted if the lender that refinances a borrower from a risky mortgage provides refinancing to "a more stable, standard loan," in which case the lender may do so without undertaking the full underwriting process required by the new ATR rule.

What is a Qualified Mortgage?

Essentially, the hypothesis that the CPFB asserts is that a Qualified Mortgage (QM) prohibits or limit the "risky features that harmed consumers in the recent mortgage crisis." Therefore, lenders will be presumed to have complied with the Ability-to-Repay rule if they issue Qualified Mortgages.

There are four (4) component features to the QM.

Component 1: No Excess Upfront Points and Fees.

The QM limits points and fees, including those used to compensate loan originators (i.e., loan officers and brokers).

Component 2: No Toxic Loan Features.

A QM cannot have the loan features that were previously "associated with risky mortgages in the lead up to the crisis." So, in the CFPB's view, certain loans cannot be QMs, such as:

-Interest-only loans (viz., consumer only pays the interest for a specified amount of time, does not decrease with payments);
-Loans where the principal amount increases (viz., negative-amortization loans); and
-Loans where the term is longer than 30 years.

Component 3: Cap on How Much Income may go toward Debt.

QMs are "generally" provided to people who have debt-to-income (DTI) ratios less than or equal to forty-three (43%) percent. This is obviously a cap on debt which, according to the CFPB, ensures consumers are only getting what they can likely afford. Most importantly, the general rule requires that monthly payments be calculated based on the highest payment that will apply in the first five years of the loan and that the consumer have a total (or "back-end") debt-to-income ratio that is less than or equal to 43 percent.

Note: for a temporary, transitional period, loans that do not have a 43 DTI but meet

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government affordability or other standards will be considered QMs. [Examples of such other standards are loans eligible for purchase by the Federal National Mortgage Association (Fannie Mae) or the Federal Home Loan Mortgage Corporation (Freddie Mac)]

Component 4: Balloon Loans in Rural or Underserved Areas

In the first place, QMs may not be loans with balloon payments. However, a "small creditor" that originates loans in rural or underserved areas is permitted to originate such loans as QMs, though the circumstances under which such loans are permitted, even in that instances, are subject to certain defined circumstances

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Types of Qualified Mortgages

There are two (2) types of QMs, each of which differ with respect to legal and regulatory consequences.

Type 1: Qualified Mortgages with Rebuttable Presumption

These are higher-priced loans typically for consumers with insufficient or weak credit history. If the loan does not perform, the consumer can rebut the presumption that the creditor properly took into account their ability to repay the loan. In other words, the borrowers would have to prove that the lender did not consider their living expenses after their mortgage and other debts. But, it should be noted that this action does not affect the rights of a consumer to challenge a lender for violating any other federal consumer protection laws.

Type 2: Qualified Mortgages with Safe Harbor

These are lower-priced loans that are typically made to borrowers who pose fewer risks. If the loan does not perform, the lender will be considered to have legally satisfied the ability-to-repay requirements. That said, the consumers can still legally challenge their lender under this rule if they believe that the loan does not meet the definition of a Qualified Mortgage. And, as I've indicated above, this action does not affect the rights of a consumer to challenge a lender for violating any other federal consumer protection laws.

Summation

The Dodd-Frank Act did not specify whether the presumption of compliance is conclusive (i.e., creates a safe harbor) or is rebuttable.

The Final Rule, however, does provide a safe harbor for loans that satisfy the definition of a qualified mortgage and are also not "higher-priced." The Final Rule provides a rebuttable presumption for higher-priced mortgage loans.

The CFPB clearly has drawn a distinction between prime loans from subprime loans. Under the existing regulations that were adopted by the FRB in 2008, only higher-priced mortgage loans (viz., HPMLs) are subject to an ATR rule and a rebuttable presumption of compliance if lenders follow certain requirements. The Final Rule further strengthens the requirements needed to qualify for a rebuttable presumption for subprime loans and further defines with more particularity the grounds for rebutting the presumption.

Specifically, the final rule provides that consumers may show a violation with regard to a subprime qualified mortgage by showing that, at the time the loan was originated, the consumer's income and debt obligations left insufficient residual income or assets to meet living expenses.

In litigation, I am sure that an analysis would be include consideration of the consumer's monthly payments on the loan, loan-related obligations, and any simultaneous loans of which the lender was aware, as well as any recurring, material living expenses of which the lender was aware. It is worth noting that guidance accompanying the Final Rule holds that the longer the period of time that the consumer has demonstrated an actual ability to repay the loan by making timely payments, without modification or accommodation, after consummation or, for an adjustable-rate mortgage, after recast, the less likely the consumer will be able to rebut the presumption based on insufficient residual income. But such performance criteria are, as they have always been and will continue to be, the very substance of such litigation.

With respect to prime loans – which were not covered by the FRB's ATR rule - the Final Rule applies the new ATR requirement, but it also creates a strong presumption for those prime loans that constitute QMs. Thus, if a prime loan satisfies the QM criteria, it will be conclusively presumed that the lender made a good faith and reasonable determination of the consumer's ability to repay. Hence, the Safe Harbor.

Regarding the cap at 43 DTI, obviously the CFPB believes that there are many instances in which individual consumers can afford a debt-to-income ratio above 43 percent based on their particular circumstances, but that such loans are better evaluated on an individual basis under the ATR criteria rather than with a blanket presumption. Straying away from the Safe Harbor to the Rebuttable Presumption will be a challenge for lenders to consider during the underwriting stage in the loan flow process.

The CFPB seems to maintain the view that lenders may initially be reluctant to make loans that are not QMs, even though they are responsibly underwritten. So, the Final Rule provides for a second, temporary category of QMs that have more flexible underwriting requirements, so long as they satisfy "the general product feature prerequisites for a qualified mortgage" and also "satisfy the underwriting requirements" of, and are therefore eligible to be purchased, guaranteed or insured by either (1) the GSEs while they operate under Federal conservatorship or receivership, or (2) the U.S. Department of Housing and Urban Development, Department of Veterans Affairs, or Department of Agriculture or Rural Housing Service. As I've noted above, this temporary provision will phase out over time as the various Federal agencies issue their own QM rules and if GSE conservatorship ends, and in any event after seven years.

The Final Rule also implements Dodd-Frank Act provisions that generally prohibit prepayment penalties except for certain fixed-rate QMs where the penalties satisfy certain restrictions and the lender has offered the consumer an alternative loan without such penalties. To match with certain statutory changes, the Final Rule also lengthens to three (3) years the time lenders must retain records that evidence compliance with ATR and prepayment penalty provisions and prohibits evasion of the Final Rule by structuring a closed-end extension of credit which does not meet the definition of open-end credit as an open-end plan.

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Summary of the Ability-to-Repay and Qualified Mortgage Rule and the Concurrent Proposal

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