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Are You Ready for the CFPB's Ability-to-Repay / Qualified Mortgage Rule?

In response to the recent financial crisis, the federal government created the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) in July of 2010. One of the requirements of this act addressed the concern that significant numbers of residential mortgages were being originated to borrowers who did not have the ability to repay their loans. As a result, the Consumer Financial Protection Bureau (CFPB), the new regulatory agency created from Dodd-Frank, developed the final rules to address the issue of ability-to-repay.

On January 10, 2013, the CFPB released its final rule on the "ability-to-repay" requirements, including the definition of "Qualified Mortgage" (QM). The rule requires lenders to, among other things, consider and evaluate whether prospective borrowers have the ability to repay their mortgage loans over the long term. The rule seeks to prohibit what the CFPB has identified as "risky lending practices" that contributed to the 2008 housing crisis. This new rule will become effective on January 10, 2014. With less than a year to implement the new rule since the announcement, mortgage lenders are under pressure to understand the details of the rule and develop the procedures and processes to comply with these regulations. Loans found not to be in compliance with the ability-to-repay rule are subject to a three-year right of rescission. In addition, noncompliance with the ability-to-repay rule can be used by the borrower as a foreclosure defense with no time limitation.

The ability-to-repay rule allows for multiple ways for a creditor to comply:

1. The creditor must consider, verify and document eight factors listed in the rule before originating the mortgage. A creditor must use reasonably reliable third-party records to verify the information used to evaluate the following eight factors:
    - Current or reasonably expected income or assets, other than value of dwelling;
    - Current employment status, if the creditor relies on employment income;
    - Monthly payment on the transaction;
    - Monthly payment on any simultaneous loan about which the creditor knows or should know will be made;
    - Monthly payment for mortgage-related obligations;
    - Current debt obligations, alimony, and child support;
    - Monthly debt-to-income ratio or residual income; and
    - Credit history.

2. In order to help lenders effectively comply with the rule and limit their exposure to costly litigation, the CFPB created the "Qualified Mortgage." Basically, originating a Qualified Mortgage (QM) will satisfy the requirement of the eight factors. A Qualified Mortgage must:

    - Provide regular periodic payments;

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- Not include negative amortization, interest only or balloon features, or have a loan term exceeding 30 years;
- Not have total points and fees exceeding 3% of the total loan amount for loans greater than $100,000 (there are different limits for loans of lesser amounts);
- Have a debt-to-income (DTI) ratio that does not exceed 43%;
- Calculate DTI using the maximum interest rate during the first five years; and
- Have considered and verified income and/or assets and current debt obligations.

3. As an alternative to the QM requirements noted above, a loan can be treated as a QM if it satisfies the QM requirements for regular periodic payment, loan term, and points and fees and is eligible for purchase by Fannie Mae and Freddie Mac, or insured by HUD/FHA, VA or the Department of Agriculture.

Loan types that have been excluded from the QM definition include open-end credit plans, timeshare plans, reverse mortgages, temporary loans (term 12 months or less), and construction phase of construction/permanent loans. QM is not to be confused with Qualified Residential Mortgage (QRM), which will require issuers of mortgage-backed securities (MBS) to retain a minimum economic interest in the MBS unless the assets meet certain underwriting standards for reduced credit risk. The official CFPB pronouncement on QRM is still pending.

As previously stated, the penalties for violating this law can be severe. In an effort to provide confidence to lenders and investors that mortgages meet the ability-to-repay rule, the CFPB has created lender protections for mortgages meeting the QM definition. As such, the CFPB defined two types of QMs. Each has different protective features and different legal consequences:

- Qualified Mortgages that provide a safe harbor
- Qualified Mortgages with a rebuttable presumption

The safe harbor is applicable if QM requirements are met and the APR does not exceed the Average Prime Offer Rate (APOR) by 1.5 percentage points or more (3.5 percentage points for subordinate-lien transactions). The safe harbor does not preclude borrowers from challenging lenders if the loan does not otherwise meet the definition of a Qualified Mortgage or for violating any other federal consumer protection.

If QM requirements have been met, but the interest rate exceeds the limits above, there will be a rebuttable presumption that the loan meets the ability-to-repay rule. Under a rebuttable presumption, borrowers can challenge that presumption by proving that they did not, in fact, have sufficient income to repay the mortgage loan they were given. CFPB guidance accompanying the final rule notes that the longer the period of time that the borrower has demonstrated an actual ability to

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repay the loan by making timely payments, the less likely the borrower will be able to rebut the presumption.

The rule provides an exemption from the ability-to-pay requirements for borrowers attempting to refinance a risky or "non-standard" mortgage to a more stable, "standard" loan if certain conditions are met.

A non-standard mortgage under the rule is a mortgage that can lead to "payment shock" and that can result in default, and includes loans such as:

- An adjustable-rate mortgage with an introductory fixed interest rate for a period of one year or longer;
- An interest-only loan; and
- A negative amortization loan.

A standard mortgage under the refinance rule must have required characteristics such as:

- A fixed interest rate for at least the first five (5) years;
- Term ≤ 40 years;
- Proceeds used only to pay off non-standard loan and closing costs; no "cash out" permitted;
- Lower monthly payments result;
- Total points and fees that do not exceed 3 percent of the loan amount.

The non-standard to standard refinance option can occur if the creditor receives the consumer's written application for a standard mortgage no later than two months after non-standard mortgage loan rate "recasts."

With the enactment of these new rules, a lender is now prohibited from making a mortgage loan without determining the borrower's ability to repay. No longer can lenders make quick sales by not requiring any or very limited documentation from the borrower or base their evaluation of the borrower's ability to repay the loans on "teaser" rates. Creditors must now evaluate the borrower's financial condition in greater detail and be able to conclude with confidence that the borrower has the ability to repay the loans.

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