

SUMMARY OF THE ABILITY-TO-REPAY AND QUALIFIED MORTGAGE RULE AND THE CONCURRENT PROPOSAL

The Consumer Financial Protection Bureau (Bureau) is issuing a final rule to implement laws requiring mortgage lenders to consider consumers' ability to repay home loans before extending them credit. The rule will take effect on January 10, 2014.

The Bureau is also releasing a proposal to seek comment on whether to adjust the final rule for certain community-based lenders, housing stabilization programs, certain refinancing programs of the Federal National Mortgage Association (Fannie Mae) or the Federal Home Loan Mortgage Corporation (Freddie Mac) (collectively, the GSEs) and Federal agencies, and small portfolio creditors. The Bureau expects to finalize the concurrent proposal this spring so that affected creditors can prepare for the January 2014 effective date.

Background

During the years preceding the mortgage crisis, too many mortgages were made to consumers without regard to the consumer's ability to repay the loans. Loose underwriting practices by some creditors—including failure to verify the consumer's income or debts and qualifying consumers for mortgages based on “teaser” interest rates that would cause monthly payments to jump to unaffordable levels after the first few years—contributed to a mortgage crisis that led to the nation's most serious recession since the Great Depression.

In response to this crisis, in 2008 the Federal Reserve Board (Board) adopted a rule under the Truth in Lending Act which prohibits creditors from making “higher-price mortgage loans” without assessing consumers' ability to repay the loans. Under the Board's rule, a creditor is presumed to have complied with the ability-to-repay requirement if the creditor follows certain specified underwriting practices. This rule has been in effect since October 2009.

In the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act, Congress 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. Congress also established a presumption of compliance for a certain category of mortgages, called “qualified mortgages.” These provisions are similar, but not identical to, the Board’s 2008 rule and cover the entire mortgage market rather than simply higher-priced mortgages. The Board proposed a rule to implement the new statutory requirements before authority passed to the Bureau to finalize the rule.

Summary of Final Rule

The final rule contains the following key elements:

Ability-to-Repay Determinations. The final rule describes certain minimum requirements for creditors making ability-to-repay determinations, but does not dictate that they follow particular underwriting models. At a minimum, creditors generally must consider eight underwriting factors: (1) current or reasonably expected income or assets; (2) current employment status; (3) the monthly payment on the covered transaction; (4) the monthly payment on any simultaneous loan; (5) the monthly payment for mortgage-related obligations; (6) current debt obligations, alimony, and child support; (7) the monthly debt-to-income ratio or residual income; and (8) credit history. Creditors must generally use reasonably reliable third-party records to verify the information they use to evaluate the factors.

The rule provides guidance as to the application of these factors under the statute. For example, monthly payments must generally be calculated by assuming that the loan is repaid in substantially equal monthly payments during its term. For adjustable-rate mortgages, the monthly payment must be calculated using the fully indexed rate or an introductory rate,

whichever is higher. Special payment calculation rules apply for loans with balloon payments, interest-only payments, or negative amortization.

The final rule also provides special rules to encourage creditors to refinance “non-standard mortgages”—which include various types of mortgages which can lead to payment shock that can result in default—into “standard mortgages” with fixed rates for at least five years that reduce consumers’ monthly payments.

Presumption for Qualified Mortgages. The Dodd-Frank Act provides that “qualified mortgages” are entitled to a presumption that the creditor making the loan satisfied the ability-to-repay requirements. However, the Act did not specify whether the presumption of compliance is conclusive (*i.e.*, creates a safe harbor) or is rebuttable. The final rule provides a safe harbor for loans that satisfy the definition of a qualified mortgage and are not “higher-priced,” as generally defined by the Board’s 2008 rule. The final rule provides a rebuttable presumption for higher-priced mortgage loans, as described further below.

The line the Bureau is drawing is one that has long been recognized as a rule of thumb to separate prime loans from subprime loans. Indeed, under the existing regulations that were adopted by the Board in 2008, only higher-priced mortgage loans are subject to an ability-to-repay requirement and a rebuttable presumption of compliance if creditors follow certain requirements. The new rule strengthens the requirements needed to qualify for a rebuttable presumption for subprime loans and 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. The analysis would consider the consumer’s monthly payments on the loan, loan-

related obligations, and any simultaneous loans of which the creditor was aware, as well as any recurring, material living expenses of which the creditor was aware. Guidance accompanying the rule notes that the longer the period of time that the consumer has demonstrated 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.

With respect to prime loans—which are not currently covered by the Board’s ability-to-repay rule—the final rule applies the new ability-to-repay requirement but creates a strong presumption for those prime loans that constitute qualified mortgages. Thus, if a prime loan satisfies the qualified mortgage criteria described below, it will be conclusively presumed that the creditor made a good faith and reasonable determination of the consumer’s ability to repay.

General Requirements for Qualified Mortgages. The Dodd-Frank Act sets certain product-feature prerequisites and affordability underwriting requirements for qualified mortgages and vests discretion in the Bureau to decide whether additional underwriting or other requirements should apply. The final rule implements the statutory criteria, which generally prohibit loans with negative amortization, interest-only payments, balloon payments, or terms exceeding 30 years from being qualified mortgages. So-called “no-doc” loans where the creditor does not verify income or assets also cannot be qualified mortgages. Finally, a loan generally cannot be a qualified mortgage if the points and fees paid by the consumer exceed three percent of the total loan amount, although certain “bona fide discount points” are excluded for prime loans. The rule provides guidance on the calculation of points and fees and thresholds for smaller loans.

The final rule also establishes general underwriting criteria for qualified mortgages. 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. The appendix to the rule details the calculation of debt-to-income for these purposes, drawing upon Federal Housing Administration guidelines for such calculations. The Bureau believes that these criteria will protect consumers by ensuring that creditors use a set of underwriting requirements that generally safeguard affordability. At the same time, these criteria provide bright lines for creditors who want to make qualified mortgages.

The Bureau also 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 ability-to-repay criteria rather than with a blanket presumption. In light of the fragile state of the mortgage market as a result of the recent mortgage crisis, however, the Bureau is concerned that creditors may initially be reluctant to make loans that are not qualified mortgages, even though they are responsibly underwritten. The final rule therefore provides for a second, temporary category of qualified mortgages 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. This temporary provision will phase out

over time as the various Federal agencies issue their own qualified mortgage rules and if GSE conservatorship ends, and in any event after seven years.

Rural Balloon-Payment Qualified Mortgages. The final rule also implements a special provision in the Dodd-Frank Act that would treat certain balloon-payment loans as qualified mortgages if they are originated and held in portfolio by small creditors operating predominantly in rural or underserved areas. This provision is designed to assure credit availability in rural areas, where some creditors may only offer balloon-payment mortgages. Loans are only eligible if they have a term of at least five years, a fixed-interest rate, and meet certain basic underwriting standards; debt-to-income ratios must be considered but are not subject to the 43 percent general requirement.

Creditors are only eligible to make rural balloon-payment qualified mortgages if they originate at least 50 percent of their first-lien mortgages in counties that are rural or underserved, have less than \$2 billion in assets, and (along with their affiliates) originate no more than 500 first-lien mortgages per year. The Bureau will designate a list of “rural” and “underserved” counties each year, and has defined coverage more broadly than originally had been proposed. Creditors must generally hold the loans on their portfolios for three years in order to maintain their “qualified mortgage” status.

Other Final Rule Provisions. The final rule also implements Dodd-Frank Act provisions that generally prohibit prepayment penalties except for certain fixed-rate, qualified mortgages where the penalties satisfy certain restrictions and the creditor has offered the consumer an alternative loan without such penalties. To match with certain statutory changes, the final rule also lengthens to three years the time creditors must retain records that evidence compliance with the ability-to-repay and prepayment penalty provisions and prohibits evasion of the rule by

structuring a closed-end extension of credit that does not meet the definition of open-end credit as an open-end plan.

Summary of Concurrent Proposal

The concurrent proposal seeks comment on whether the general ability-to-repay and qualified mortgage rule should be modified to address potential adverse consequences on certain narrowly-defined categories of lending programs. Because those measures were not proposed by the Board originally, the Bureau believes additional public input would be helpful. Specifically, the proposal seeks comment on whether it would be appropriate to exempt designated non-profit lenders, homeownership stabilization programs, and certain Federal agency and GSE refinancing programs from the ability-to-repay requirements because they are subject to their own specialized underwriting criteria.

The proposal also seeks comment on whether to create a new category of qualified mortgages, similar to the one for rural balloon-payment loans, for loans without balloon-payment features that are originated and held on portfolio by small creditors. The new category would not be limited to lenders that operate predominantly in rural or underserved areas, but would use the same general size thresholds and other criteria as the rural balloon-payment rules. The proposal also seeks comment on whether to increase the threshold separating safe harbor and rebuttable presumption qualified mortgages for both rural balloon-payment qualified mortgages and the new small portfolio qualified mortgages, in light of the fact that small creditors often have higher costs of funds than larger creditors. Specifically, the Bureau is proposing a threshold of 3.5 percentage points above APOR for first-lien loans.