Ability-to-Repay Rule

Protecting Homebuyers from Debt Traps

On January 10, 2014, the Consumer Financial Protection Bureau's Ability-to-Repay Rule will go into effect. This rule protects consumers from debt traps by requiring mortgage lenders to evaluate whether borrowers can afford to pay back the mortgage before signing them up. The rule was required by Congress, as a response to the financial crisis and nationwide foreclosure epidemic.

Under the new Ability-to-Repay Rule, mortgage lenders must look at customers' income, assets, savings, and debt, and weigh those against the monthly payments over the long term – not just a teaser or introductory rate period. As long as they check the numbers and the numbers check out, lenders can offer any mortgage they reasonably believe a consumer can afford. These are common-sense practices that most lenders already follow.

Certain types of mortgages are more likely to become a debt trap for the borrower, so the new rule lays out basic guidelines that lenders can follow. Loans within these guidelines are called "Qualified Mortgages," and they give lenders greater certainty that they are meeting the Ability-to-Repay requirement. If lenders choose not the follow these guidelines, they can still make a loan based on their reasonable, good-faith determination that the borrower has the ability to repay it.

To be a Qualified Mortgage, the loan:

- Cannot have excessive upfront points and fees;
- Cannot be longer than 30 years;
- Cannot have certain risky features, such as paying only interest and not principal, or paying less than the full amount of interest so that the total debt grows each month; and
- Must be in one of three categories:
    1. The monthly loan payment, plus the borrower's other debt payments, does not exceed 43 percent of the borrower's monthly income; or
    2. The loan qualifies for purchase or guarantee by a government sponsored enterprise (Fannie Mae or Freddie Mac), or is insured or guaranteed by a federal housing agency; or
    3. The loan is made by a small lender that keeps the loan in portfolio.

Bottom line: The Ability-to-Repay rule is intended to prevent consumers from getting trapped in mortgages that they cannot afford, and to prevent lenders from making loans that consumers do not have the ability to repay. It's that simple.

<u>Fact vs. Fiction</u>

1. ***Fiction:*** *The CFPB's Ability-to-Repay Rule will cut off consumers' access to credit by requiring all loans to be Qualified Mortgages.*

   Fact: The Ability-to-Repay Rule does *not* require lenders to offer any specific type of mortgage. Lenders can offer any mortgage they believe a consumer has the ability to repay, as long as they have documentation to back up their assessment. Not all loans will be Qualified Mortgages.

2. ***Fiction:*** *Banks aren't going to make any loans that are not Qualified Mortgages.*

   Fact: The Ability-to-Repay Rule is designed to protect consumers without disrupting the U.S. housing market. Some of the nation's largest banks have already said they plan on making loans that fall outside of the Qualified Mortgage guidelines.

   More importantly, however, the vast majority of loans being made today are already compliant with the Qualified Mortgage guidelines. The CFPB estimates that roughly 92 percent of mortgages in the current marketplace meet the Qualified Mortgage requirements, and reports by independent economists have confirmed the Bureau's calculations.

3. ***Fiction:*** *The Ability-to-Repay Rule requires all mortgages to cap debt-to-income at 43 percent.*

   Fact: The Ability-to-Repay Rule does *not* mandate debt-to-income ratios. The rule simply requires lenders to evaluate a borrower's debt-to-income ratio and use their judgment about how much debt a consumer can afford to take on.

   Nor does the Ability-to-Repay Rule require all Qualified Mortgages to meet the 43 percent debt-to-income ratio. A loan can also be a Qualified Mortgage if it meets standards for loans backed or purchased by Fannie Mae or Freddie Mac, if it's insured by a federal housing agency, or if it is offered by a small lender that holds the loan in portfolio. Right now, roughly 92 percent of mortgages fall into one of those three categories.

4. ***Fiction:*** *The new rules have excessive documentation requirements, and are going to make it nearly impossible for anyone who's self-employed or has an unusual financial situation to qualify for a mortgage.*

   Fact: Under the new rules, lenders do have to verify that consumers can afford to repay their mortgage – that's the whole point. Lenders will make that determination by looking at documents such as payroll stubs, tax returns, student loan statements, credit history, and other financial information. These documents help lenders weigh borrowers' debt against the income and assets available to pay off the debt. Without this information, lenders cannot make an accurate assessment of affordability, and borrowers could wind up in over their heads.

   Looking at this kind of documentation is something that responsible mortgage lenders have always done, and the new rule makes sure that every lender follows prudent underwriting practices.

   The rule is designed to preserve consumers' access to credit, and the CFPB has issued guidance to small lenders with advice on how to verify seasonal or irregular income.

5. ***Fiction:*** *The new rule requires 20 percent or 30 percent down payments for new mortgages, which will price many borrowers out of the market.*

   Fact: The Ability-to-Repay Rule and Qualified Mortgage guidelines do not establish a minimum down payment.

6. ***Fiction:*** *The points and fees cap is going to put mortgage brokers out of business, and ultimately will harm consumers who will just end up paying higher interest rates.*

   Fact: The Ability-to-Repay Rule does *not* cap all points and fees. Loans that are not Qualified Mortgages have no restrictions on the total amount of points and fees.

   If a loan is a Qualified Mortgage, it cannot include upfront points and fees greater than 3 percent of the total loan amount. Excessive upfront fees can encourage a "take the money and run" business model, where lenders do not have a big financial incentive to evaluate the riskiness of the loan because they make most of their money at the closing table. The 3 percent cap on Qualified Mortgage fees is a reasonable limit that protects consumers and gives lenders the incentive to evaluate affordability over the life of the loan. The rule also makes allowances for smaller mortgages to ensure that responsible loans are not unintentionally affected.

7. ***Fiction:*** *Lenders haven't had enough time to update their systems and get ready for the new rules. The CFPB has amended the rules repeatedly, making it impossible for lenders to adapt in time.*

   Fact: The Ability-to-Repay Rule was finalized in January 2013, a full year before it was scheduled to take effect. The CFPB has issued various amendments over the course of the year, with a single aim in mind: to ensure the effectiveness of the rules by making it easier for lenders to comply. The Bureau recognizes that coming into compliance with the rules is a significant challenge, and it has worked closely with the industry to answer questions, provide resources, and address concerns.

   Housing industry experts have predicted that most new mortgage originations will not be affected by the new rules when they take effect on January 10, and the Mortgage Bankers Association has said that "many lenders are already acting as if the rule is in place."