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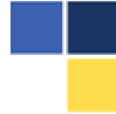

Corporate / Financial Institutions ALERT

Consumer Financial Protection Bureau Adopts Ability to Repay and Qualified Mortgage Rules

January 24, 2013

Summary

On Thursday, January 10, 2013, the Consumer Financial Protection Bureau (CFPB) released its Final Rule setting forth new "ability-to-repay" determination requirements that will appy to traditional residential mortgages and any other consumer credit transaction secured by a dwelling. Under the rule, lenders are required to make a good faith determination that the borrower has the ability to repay the loan prior to making a mortgage or dwelling secured loan.

As mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd Frank), the rule also provides that if a lender makes a "qualified mortgage" (as defined in the rule), the lender will receive special protection from liability if the borrower contests the lender's compliance with the ability-to-repay determination requirements.

The Final Rule will go into effect on January 10, 2014.

Ability-to-Repay Determination

The Final Rule does not dictate any particular loan underwriting standards that lenders or creditors must follow when making a mortgage or loan secured by a dwelling. Instead, it describes eight factors that lenders must consider and verify in order to make an ability-to-repay determination. A lender will, in effect, be responsible for making loans that borrowers can repay.

At a minimum, the following factors must be evaluated by the lender when determining a borrower's ability to repay:

- current or reasonably anticipated income and assets;
- current employment status;
- the calculated monthly payment on the mortgage or dwelling secured loan, assuming that the loan will be repaid in substantially equal monthly payments during its term;
- the monthly payment on any simultaneous loan, such as a home equity line of credit (HELOC);
- monthly payments for mortgage-related obligations, such as property taxes and insurance;

- current other debt, alimony and child support obligations;
- monthly debt-to-income ratio or residual income; and
- credit history.

Lenders are expected to use reasonably reliable third-party records in order to verify the information they use to make an ability-to-repay determination. The information and other evidence compiled by lenders in making these determinations must be maintained for three years after making a mortgage or dwelling loan.

These new required ability-to-repay lender determinations, when coupled with the verification requirements, will effectively end the use of “no document” and “low document” mortgage loans.

The ability-to-repay criteria apply to any consumer loan transaction secured by dwelling other than HELOCs, timeshare loans, reverse mortgages and temporary loans (e.g., construction loans) with a term of 12 months or less.

Qualified Mortgages

Under the Final Rule, a residential loan will be considered as a qualified mortgage if each of the following criteria are met:

- the borrower’s income or assets must be verified and documented;
- the loan monthly payments are calculated on the highest payment that will apply during the first five years of the loan term (for adjustable-rate mortgages, the monthly payments are calculated using the fully-indexed rate or an introductory rate, whichever is higher);
- periodic payments must generally be substantially equal and result in a reduction of principal;
- for loans exceeding $100,000, the total points and fees may not exceed 3 percent of the total loan amount (*subject to limited exceptions*);
- the borrower’s debt to income ratio may not be greater than 43 percent (*subject to limited exceptions*);
- the loan may not contain features that provide for interest-only payments, negative-amortization payments where the principal amount increases, or balloon payments (*subject to limited exceptions*); and
- the loan term must not exceed 30 years.

Qualified Mortgage Lender Liability Protections

If a mortgage satisfies the qualified-mortgage criteria, the Final Rule establishes either a safe harbor for potential lender liability based upon claims that the lender failed to satisfy the ability-to-repay requirements or a rebuttable presumption that the requirements have been met by the lender. The Final Rule, in effect, distinguishes the lender's liability protection based upon whether the loan is a "standard or prime" rate loan or if it constitutes a "higher priced" loan.

Standard or Prime Rate Loan Safe Harbor Presumption

For standard or prime rate loans that satisfy the qualified-mortgage criteria, the Final Rule establishes a presumptive safe harbor that the lender satisfied the ability-to-repay requirements. A standard or prime rate loan must carry an annual percentage rate (APR) that does not exceed the average prime offer rate for a comparable transaction as set by the CFPB by 150 basis points for a first lien transaction or, in the case of a subordinate lien transaction, it must carry an APR that does not exceed the average prime rate offer for a comparable transaction by 350 basis points. However, this safe harbor does not preclude a borrower from challenging a lender if the loan does not otherwise meet the definition of a qualified mortgage or if it violates any other federal consumer protection.

Higher Priced Loan Rebuttable Presumption

Lenders offering Higher Priced Qualified Mortgages (HPQM) will only be provided a rebuttable presumption if the borrower has met the ability-to-repay requirements. An HPQM is defined as having an APR in excess of 150 basis points above the average prime-offer rate for a comparable first lien transaction as set by the CFPB or having an APR in excess of 350 basis points above the prime-offer rate for a comparable subordinate lien transaction. With respect to an HPQM, a borrower will still have the right to challenge the rebuttable presumption of ability to repay by demonstrating that at the time the mortgage loan was made the borrower's income and debt obligations left insufficient residual income or assets to repay the mortgage loan. Significantly, the Final Rule does provide that the longer a borrower waits from the time of making the HPQM to make a claim of the borrower's inability to repay, the less likely that the presumption will be overcome in favor of the borrower.

Final Rule – Limited Exemptions

Refinancing Nonstandard Mortgages

The Final Rule provides a special limited exemption from the ability-to-repay requirements in order to allow for the replacement and refinancing of nonstandard mortgage loans issued before January 10, 2014, that feature interest-only, negative amortization or adjustable rates provisions. In order for the ability-to-repay refinancing exemption to apply, each of the following criteria must be satisfied:

- the new mortgage is likely to prevent a default of the nonstandard mortgage;
- the new lender must be the holder or the servicer for the prior nonstandard mortgage loan;

- the new monthly payments must be materially less than the monthly payments required under the nonstandard mortgage loan, with a 10 percent safe harbor;
- no more than one nonstandard mortgage payment has been more than 30 days late in the 12-month period prior to the lender's receipt of a refinancing application, and no payments may be more than 30 days late in the preceding six months;
- the new mortgage does not cause the principal balance to increase and may not provide for any deferred payments or balloon payments;
- the new mortgage must not provide for total points and fees that exceed the maximum allowed under a qualified mortgage (generally 3 percent);
- interest on the refinanced mortgage must be fixed for a period of at least five years; and
- the term of the new mortgage may not exceed 40 years.

Rural Area Qualified Mortgages

The general qualified mortgage conditions and criteria may affect the availability of mortgage loans in certain rural and underserved areas where lenders may only offer mortgage loans that provide for balloon payment features. The Final Rule creates a special category of mortgage loans that allow for balloon payments and that will be deemed to be a qualified mortgage. In order to be considered a qualified mortgage, these mortgage loans must have a fixed interest rate, have a term of at least five years, and satisfy basic loan underwriting standards. While the borrower's debt-to-income ratio should be considered as a part of the mortgage loan underwriting, these special qualified mortgages will not be subject to the 43 percent debt-to-income ratio that otherwise applies to other standard qualified mortgages.

Lenders will only be eligible to make rural balloon payment 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 originate no more than 500 first-lien mortgages per year. The CFPB will issue a list of areas deemed to be rural or underserved on an annual basis.

Temporary Qualified Mortgages

In light of concern that lenders will not be willing to make mortgage loans that do not meet the basic conditions of a qualified mortgage, the Final Rule provides for a temporary category of qualified mortgages that will be exempt from the 43 percent debt-to-income ratio requirement during a transitional period. These mortgage loans must otherwise satisfy the general product feature prerequisites for a qualified mortgage and also satisfy the underwriting requirements of and be eligible to be purchased, guaranteed or insured by either Fannie May or Freddie Mac, the U.S. Department of Housing and Urban Development, the U.S. Department of Veterans Affairs, the U.S. Department of Agriculture (USDA) or the USDA Rural Housing Service. This temporary provision will expire on January 10, 2021.

"Qualified Mortgages" Are Different From "Qualified Residential Mortgages"

Section 941 of Dodd Frank generally requires that mortgage originators who seek to issue asset-backed securities consisting of mortgages must retain some degree of risk. Under this provision, a "qualified residential mortgage" will be exempt from the general asset backed risk retention requirement. In addition, the definition of a "qualified residential mortgage" cannot be broader than the definition of a qualified mortgage. The adoption of the qualified mortgage definition should spur the adoption of the "qualified residential mortgage" definition.

For further information, please contact Tim Sullivan, Michael D. Morehead or your regular Hinshaw attorney.

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