

# Analysis of CFPB's New Ability-to-Repay Rule for Qualified Mortgages

Article By:

Michael G. Dailey

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On Dec. 29, 2020, the Consumer Financial Protection Bureau (CFPB) published a final rule amending Regulation Z's Ability-to-Repay/Qualified Mortgage (QM) requirements (the New Rule). Regulation Z requires creditors to make a reasonable, good-faith determination of a consumer's ability to repay their residential mortgage loan. Loans that comply with Regulation Z's requirements qualify for certain protections from liability.

The New Rule went into effect March 1, 2021, with consumer loan applications filed on or after July 1, 2021, subject to mandatory compliance. The New Rule replaces the strict 43% debt-to-income (DTI) ratio analysis with a loan price-based analysis tied to annual percentage rate (APR) limits, amends creditors' "consider and verify" obligations, and creates a new class of QMs. In addition, effective July 1, 2021, the New Rule permanently eliminated the existing GSE Patch.

## Elimination of the DTI Standard for Qualified Mortgages

Under the former version of Regulation Z, in order to satisfy the Ability-to-Repay Rule for a General QM, the creditor had to verify that the consumer's DTI ratio was under 43% according to the standards listed in Appendix Q of Regulation Z.<sup>[1]</sup> The New Rule eliminates the 43% DTI standard in favor of a loan price-based standard, although the creditor is still obligated to consider an applicant's DTI as part of the new "consider and verify" rules discussed below.

To be considered a General QM under the New Rule, the APR on the loan must not exceed the average prime offer rate (APOR) for a comparable transaction by more than the following thresholds<sup>[2]</sup>:

- For a first lien transaction where the loan amount is greater than or equal to \$110,260.00, the threshold is 2.25 percentage points.<sup>[3]</sup>
- For a first lien transaction where the loan amount is \$66,156.00 or more, but less than \$110,260.00, the threshold is 3.5 or more percentage points.<sup>[4]</sup>
- For a first lien transaction where the loan amount is less than \$66,156.00, the threshold is 6.5

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or more percentage points.<sup>[5]</sup>

The New Rule specifies alternative thresholds for loans secured by manufactured homes and for subordinate loans.<sup>[6]</sup>

The New Rule also mandates the calculation that creditors must use to determine the proper APR of an adjustable rate mortgage (ARM) when comparing the APR of the loan to the APOR for purposes of the General QM analysis above. For a loan for which the interest rate may or will change within the first five years, the applicable APR is based on the maximum interest rate that may apply during that five-year period.<sup>[7]</sup> This rate is then used as the interest rate for the full term of the loan.<sup>[8]</sup> According to the CFPB, this provision applies primarily to short reset ARMs<sup>[9]</sup> and is designed to mitigate ability-to-repay risks associated with the potential for payment shock when these loans adjust.<sup>[10]</sup>

Despite these changes regarding the determination of whether a loan meets the definition of a General QM, the New Rule preserved the existing threshold for General QMs that qualify for safe harbor (protection from liability via a conclusive presumption that the creditor met Regulation Z's Ability to Repay loan underwriting standard). A loan is still considered a safe harbor QM as long as its APR does not exceed the APOR for a comparable transaction by more than 1.5 percentage points (3.5 percentage points for subordinate-lien loans) as of the date the interest rate is set.

In contrast to the safe harbor, the rebuttable presumption of compliance provides lenders with a weaker shield from borrower litigation. To rebut the presumption of compliance, the borrower must prove that the lender failed to make a reasonable and good-faith determination of the consumer's ability to repay at the time the loan was made. In order to qualify for the rebuttable presumption, the APR can exceed 1.5 percentage points but must remain below the threshold of 2.25 percentage points.<sup>[11]</sup>

## The “Consider and Verify” Requirements

In accordance with the shift to a loan-price analysis, the new rule removes Appendix Q, formerly used by creditors to determine the consumer's DTI ratio. However, the New Rule does not eliminate consideration of DTI altogether. Instead, it reframes the burden on creditors as two separate requirements: (1) to consider “the consumer's income or assets, debt obligations, alimony, child support, and monthly DTI ratio or residual income” and (2) to verify that information using reasonably reliable third-party records.<sup>[12]</sup>

Creditors must maintain written policies and procedures to guide their consideration processes, and retain documents detailing how they considered the above factors as part of the loan process for each General QM.<sup>[13]</sup> The retained documents for each loan must show how the creditor took into account the required factors in its ability-to-repay analysis, as well as how it applied the attendant policies and procedures.<sup>[14]</sup> The point of the written policies and procedures and the required document retention is to allow any third party to confirm that the creditor did, in fact, consider the required factors and ensure that the underwriting was sufficiently rigorous.<sup>[15]</sup>

The New Rule clarifies the operation of the verification component in a new comment, which explains that a creditor would not meet the verification requirement if it observed an unidentified \$5,000 deposit in a consumer's account but neglected to take appropriate steps to confirm that the deposit was personal income rather than the proceeds of a loan disbursement.<sup>[16]</sup> Finally, there is a safe harbor for the verification requirement if the creditor meets verification standards in the current

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version of the following publications:

- Fannie Mae’s Single-Family Selling Guide
- Freddie Mac’s Single-Family Seller/Servicer Guide
- FHA’s Single-Family Housing Policy Handbook
- The VA’s Lenders Handbook
- Field Office Handbook for the Direct Single-Family Housing Program and Handbook for the Single-Family Guaranteed Loan Program of the USDA<sup>[17]</sup>

Creditors can mix and match verification standards from these manuals and future versions of these publications will qualify for the verification safe harbor, provided that the revised version is substantially similar.<sup>[18]</sup>

## **The Seasoned Qualified Mortgage**

Concurrent with the revised definition of the General QM, the CFPB created a new category of QM, called Seasoned Qualified Mortgage, in an effort to encourage responsible innovation in the mortgage origination market.<sup>[19]</sup> Under the new category, a loan will receive safe harbor from ability-to-repay liability at the end of a minimum three-year seasoning period, provided certain requirements are satisfied.<sup>[20]</sup> Loan applications received on or after March 31, 2021, will be eligible for Seasoned QM status after the three-year seasoning period.<sup>[21]</sup> To become a Seasoned QM, the loan must:

1. Be secured by a first lien;
2. Have a fixed rate, with regular, substantially equal periodic payments that are fully amortizing and no balloon payments;
3. Not exceed a 30-year repayment term;
4. Not be a high-cost mortgage as defined in § 1026.32(a) of Regulation Z; and
5. Have points and fees that fall within specified limits.<sup>[22]</sup>

A Seasoned QM is also subject to the “consider and verify” requirements as stated for the General QM.<sup>[23]</sup> While the loan is generally required to remain in the creditor’s portfolio for the duration of the seasoning period, some exceptions to this requirement apply.<sup>[24]</sup>

There are also performance thresholds that apply to the borrowers. At the end of the seasoning period, loans cannot have more than two delinquencies of 30 days or more and cannot have any of 60 days or more.<sup>[25]</sup> The rule allows for up to three deficient payments (within a \$50 payment tolerance) during the seasoning period, and temporary payment accommodations will not necessarily prevent an otherwise qualified loan from becoming a Seasoned QM.<sup>[26]</sup>

## **Conclusion**

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The CFPB amended Regulation Z to keep pace with the changing mortgage market and preserve consumers' access to affordable mortgage credit while ensuring their ability to repay. As the market has evolved, the bureau was concerned that the 43% DTI threshold would limit the availability of QMs and result in reduced access to affordable credit, especially given the impending expiration of the Temporary GSE.<sup>[27]</sup> According to the CFPB, the changes outlined above account for the evolving needs of creditors and consumers and “strike the best balance between ensuring consumers' ability to repay and ensuring access to responsible, affordable mortgage credit.”<sup>[28]</sup>

Keeley Gogul also contributed to this article.

<sup>[1]</sup> Qualified Mortgage Definition Under the Truth in Lending Act (Regulation Z): General QM Loan Definition, 85 Fed. Reg. 86308 (Dec. 29, 2020) (to be codified at 12 C.F.R. pt. 1026).

<sup>[2]</sup> These loan amounts are based on the original \$100,000.00 and \$60,000.00 bases used to calculate points and fees limits elsewhere in the rule. (See §1026.43(e)(3)(i)). Under the new rule, these amounts will be “adjusted annually on January 1 by the annual percentage change in the CPI-U that was reported on the preceding June 1.” *Id.* at 86366.

<sup>[3]</sup> *Id.* at 86363.

<sup>[4]</sup> *Id.* at 86366.

<sup>[5]</sup> *Id.* at 86367.

<sup>[6]</sup> *See id.* First lien transactions secured by a manufactured home where the loan amount is less than \$110,260.00, the threshold is 6.5 or more percentage points. For subordinate loans where the loan amount is above \$66,156.00, the threshold is 3.5 or more percentage points. Subordinate loans in amounts less than \$66,156.00 must be below a threshold of 6.5 percentage points.

<sup>[7]</sup> *Id.* at 86376.

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[8] *Id.*

[9] *Id.* Short re-set ARMs are ARMs with initial fixed-rate periods of five years or less.

[10] *Id.*

[11] *Id.* at 86344, n. 258.

[12] *Id.* at 86348.

[13] *Id.* at 86350.

[14] *Id.* at 86353.

[15] *Id.* at 86352.

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[16] *Id.* at 86347.

[17] *Id.* at 86334.

[18] *Id.* at 86336.

[19] Qualified Mortgage Definition Under the Truth in Lending Act (Regulation Z): Seasoned QM Loan Definition, 85 Fed. Reg. 86402 (Dec. 29, 2020) (to be codified at 12 C.F.R. pt. 1026).

[20] *Id.*

[21] *Id.*

[22] *Id.*

[23] *Id.*

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<sup>[24]</sup> *Id.* These exceptions are similar to those for Small Creditors under the General QM Rule, and include a special exception allowing a single transfer of the loan during the seasoning period.

<sup>[25]</sup> *Id.* at 86403.

<sup>[26]</sup> *Id.*

<sup>[27]</sup> Qualified Mortgage Definition Under the Truth in Lending Act (Regulation Z): General QM Loan Definition, 85 Fed. Reg. 86308, 86317 (Dec. 29, 2020) (to be codified at 12 C.F.R. pt. 1026).

<sup>[28]</sup> *Id.*

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