Consumer Financial Protection Bureau (CFPB) Issues Final Ability-to-Repay and Qualified Mortgage Rule

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Rule lists criteria that lenders must consider in determining a prospective borrower has the ability to repay a loan and defines Dodd-Frank's concept of a "qualified mortgage."

On January 10, 2013 the **Consumer Financial Protection Bureau (CFPB)** issued its final rule,[1] "**Ability to Repay and Qualified Mortgage Standards Under the Truth in Lending Act" (Final Rule),** which defines the term "**qualified mortgage**" and interprets the **ability-to-repay requirements** mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act sections 1411–1412 (Dodd-Frank) amendments to the Truth in Lending Act. The Final Rule affects all creditors of residential mortgage loans subject to the Truth in Lending Act and goes into effect on January 10, 2014.

Ability-to-Repay Requirement

Section 1411 of Dodd-Frank states that "no creditor may make a residential mortgage loan unless the creditor makes a reasonable and good faith determination based on verified and documented information that, at the time the loan is consummated, the consumer has a reasonable ability to repay the loan, according to its terms, and all applicable taxes, insurance (including mortgage guarantee insurance), and assessments." The Final Rule requires that lenders verify several underwriting standards, including a borrower's 1) current income or assets, 2) employment status, 3) credit history, 4) monthly mortgage payment and any other mortgage-related obligations and loans associated with the property, 5) other debt obligations, and 6) monthly debt-to-income (DTI) ratio.

These ability-to-repay requirements apply to any consumer credit transaction secured by a dwelling, except a home equity line of credit subject to 12 C.F.R. § 226.5b (i.e., an open-end credit plan), a timeshare plan, a reverse mortgage, or any temporary or bridge loan with a term of 12 months or less.

Qualified Mortgage

Dodd-Frank called for the creation of a new category of loans (i.e., qualified mortgages) that would be presumed to comply with the ability-to-pay requirements. The Final Rule defines "qualified mortgages" as those that, in addition to meeting the above-identified ability-to-repay requirements, satisfy the following criteria: 1) the loan does not feature negative amortization, interest-only payments, balloon payments, or a term exceeding 30 years; 2) the total points and fees do not exceed 3% of the total loan amount for loans exceeding $100,000 (with a provision for a sliding scale of acceptable caps on fees for lesser loan amounts); 3) the borrower's income or assets are verified and documented; and 4) the borrower's DTI ratio is not greater than 43%.

According to the CFPB's extensive preamble to the Final Rule, the rule distinguishes between two types of qualified mortgages based on a mortgage's annual percentage rate relative to the average prime offer rate for comparable transactions. The rule does not provide a separate higher threshold for jumbo loans.

For loans that exceed the average prime offer rate by a specified amount—loans denominated as "higher-priced mortgage loans"—the rule provides a rebuttable presumption that the creditor has satisfied the ability-to-repay requirements, but a consumer may rebut that presumption under carefully defined circumstances. The consumer must demonstrate that, at the time the loan was made, the consumer did not, in fact, have sufficient income or assets (other than the value of the dwelling securing the loan), after paying his or her mortgage and other debts, to be able to meet his or her other living expenses of which the creditor was aware.

For all other qualified loans (i.e., loans that are not higher priced), the Final Rule provides a safe harbor—a conclusive presumption that the creditor has satisfied all of the ability-to-repay requirements—once the creditor proves that it has, in fact, made a qualified mortgage.

DTI Ratio Cap

The Final Rule establishes a maximum DTI ratio for all qualified mortgages, requiring that a borrower's DTI ratio be less than or equal to 43%. This number is to be calculated based on the highest interest rate that will apply in the first five years of the loan as opposed to any lower introductory interest rate. Otherwise, qualifying loans that are eligible to be purchased, guaranteed, or insured by the Department of Housing and Urban Development, the Department of Veterans Affairs, the Department of Agriculture, the Rural Housing Service, or the Federal National Mortgage Associate or Federal Home Loan Mortgage Corporate, while operating under federal conservatorship, are temporarily exempt from this requirement. This exemption expires at the earlier of 1) seven years after the Final Rule's effective date or 2) the issuance by the federal agencies of their own qualified mortgage rules.

Other Provisions

The Final Rule implements Dodd-Frank's prohibition of prepayment penalties except on certain fixed-rate qualifying mortgages where the penalties satisfy strict size and duration limits and where the creditor has offered the borrower an alternative loan without penalties. The Final Rule also sets a uniform period during which creditors must retain records evidencing compliance with the ability-to-repay and prepayment penalty provisions.

What the Final Rule Means for Lenders

- The use of so-called "no doc" and "low doc" mortgages has been eliminated. Lenders may no longer base ability-to-repay decisions on teaser rates, rather they must base all lending decisions on the principal and interest over the life of the mortgage.
- Interest-only loans or loans with balloon payments cannot meet the qualified-mortgage standards.
- Most qualified mortgages will have a 3% cap on the amount of fees and origination costs that lenders can charge (inclusive of title services and legal settlement charges).
- Although lenders are free to make loans that do not meet the qualified-mortgage criteria, these lenders may face difficulty reselling them on the secondary market and will not qualify for any safe-harbor protections.
- Loans made by smaller lenders in rural and underserved communities must consider the above-mentioned DTI ratio requirement as a part of their underwriting requirements but do not have to comply with the 43% ratio.
- Borrowers are not required to make a minimum down payment or meet minimum credit score requirements to obtain a qualified mortgage.

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[1]. View the Final Rule here.

National Law Review, Volume III, Number 17