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# CFPB Issues "Ability-to-Repay" Mortgage Requirements

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The Consumer Financial Protection Bureau ("CFPB") has issued a final rule implementing the "ability to repay" mortgage requirements of the Dodd-Frank Act. The rule requires creditors to make a reasonable, good faith determination of a consumer's ability to repay a closed-end consumer residential mortgage, and establishes certain protections from liability under this requirement for "qualified mortgages." The final rule is effective January 10, 2014.

## I. Scope and Overview

In the Dodd-Frank 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." The final rule issued by the CFPB and published in the Federal Register on January 30, 2013, implements this requirement by amending the CFPB's Regulation Z.

The rule applies to all consumer-purpose, closed-end loans secured by a dwelling, including home-purchase loans, refinances and home equity loans—whether first- or subordinate-lien. The rule does not apply to open-end loans, such as home equity lines of credit, and does not apply to loan modifications, except if the modification constitutes a "refinancing" under Regulation Z.

A creditor may satisfy the ability-to-repay requirements in one of four ways: (a) by considering eight identified underwriting factors, and verifying the information considered, (b) by making a "qualified mortgage," which is a mortgage that meets certain specific criteria, (c) by refinancing a "non-standard mortgage" into a "standard mortgage," and (d) for certain small creditors serving primarily rural or underserved areas, by making a qualifying balloon mortgage in such areas.

## II. Ability-to-Repay Requirements

A. Eight Underwriting Factors

The first way that a creditor may comply with the ability-to-repay requirements is to consider the following eight factors:

i. The consumer's current or reasonably expected income or assets, other than the value of the dwelling, including any real property attached to the dwelling, that secures the loan;
ii. If the creditor relies on income from the consumer's employment in determining repayment ability, the consumer's current employment status;
iii. The consumer's monthly payment on the covered transaction, calculated in accordance with specific requirements;
iv. The consumer's monthly payment on any simultaneous loan that the creditor knows or has reason to know will be made, calculated in accordance with specific requirements;
v. The consumer's monthly payment for mortgage-related obligations;
vi. The consumer's current debt obligations, alimony, and child support;
vii. The consumer's monthly debt-to-income ratio or residual income calculated in accordance with certain specific requirements; and
viii. The consumer's credit history.

A creditor must verify the information on which it bases its ability-to-repay determination by using reasonably reliable, written: “third-party records” (except that employment status may be verified orally if the creditor makes a written record of the conversation). “Third party record” generally refers to “a document or other record prepared or reviewed by an appropriate person other than the consumer, the creditor, or the mortgage broker or an agent of the creditor or mortgage broker.”

## B. Qualified Mortgage

The second way a creditor may meet the ability-to-repay requirement is if the loan is a “qualified mortgage.” To be a “qualified mortgage,” the final rule specifies that the mortgage and creditor must meet each of the following criteria:

- **Payment type.** Terms of the mortgage must not include any negative amortization, interest-only payments, or balloon payments (except in the case of mortgages originated and held in portfolio by small creditors operating in rural or underserved areas).
- **Loan term.** The loan term cannot exceed 30 years.
- **Income/assets/debt verification.** The creditor must verify the borrower’s current or reasonably expected income or assets, and current debt obligations.
- **Points and fees.** Points and fees paid by the consumer (including those used to compensate originators, such as loan officers or brokers, and fees for appraisals and title work paid to affiliates of the creditor) cannot exceed 3 percent of the total loan amount in most cases, although certain “bona fide discount points” are excluded for prime loans. The rule sets different thresholds for smaller loans.
- **Underwriting standards.** The creditor must calculate monthly payments based on the highest monthly payments required any time during the first five years of the mortgage (e.g., not on “teaser rates”) and the total debt-to-income (“DTI”) ratio must be less than or equal to 43 percent. Alternatively, for a period of up to seven years after the effective date of the rule, a mortgage that does not have a 43 percent DTI ratio but meets government affordability or other standards—such as being eligible for purchase by Fannie Mae or Freddie Mac so long as they remain in conservatorship or receivership, or programs of HUD, the VA, the USDA, or the Rural Housing Service—will be considered a “qualified mortgage” if it otherwise meets the qualified mortgage requirements.

If a mortgage is deemed a “qualified mortgage,” then a creditor will get certain protections under the final rule—either a safe harbor or a rebuttable presumption of compliance; the applicable protection will depend on whether the loan is a deemed a prime loan or a high-cost loan.

If the loan is a prime loan, meaning the interest rate is not more than 1.5 percentage points over the Average Prime Offer Rate ("APOR") for a first-lien loan or not more than 3.5 percentage points over the APOR for a subordinate lien, then the creditor gets a safe harbor. This means that a borrower has a very limited ability to establish that a loan violates the ability-to-repay requirements—the borrower will have to establish that the loan is not a qualified mortgage within the interest rate limits for a prime loan.

If the interest rate is above the thresholds for a prime loan, then the creditor gets a rebuttable presumption of compliance. This means the creditor is presumed to have complied with the ability-to-repay requirements, but the borrower can rebut the presumption by raising specific facts that demonstrate that, based on information of which the creditor was aware of at origination, the borrower's income and debt obligations at that time left insufficient income or assets to meet living expenses.

### C. Exemption for Certain Refinancings

The rule exempts creditors refinancing "non-standard mortgages" into "standard mortgages" from the ability-to-repay requirements that would otherwise apply. Non-standard mortgages include adjustable-rate mortgages with an introductory fixed interest rate for a period of one year or longer, interest-only loans, and negative amortization loans. Standard mortgages must include a fixed rate for at least five years, have total points and fees that do not exceed the 3 percent cap for qualified mortgages, have a loan term that does not exceed 40 years, and require that the proceeds of the loan only be used to pay the outstanding balance of the non-standard mortgage and closing and settlement fees for the standard mortgage.

The exemption applies only where the refinancing materially reduces the borrower's monthly payments and where the creditor has considered whether the standard mortgage likely will prevent a default by the consumer on the non-standard mortgage once the loan is recast. In addition, this treatment is available only to refinancings where the creditor holds both the original nonstandard mortgage and the new standard mortgage, the borrower's payment history meets certain performance standards, and the borrower submits a written application within two months of the date the non-standard mortgage is recast.

### D. Certain Balloon Loans Made by Small Creditors in Rural or Underserved Areas

The fourth way a creditor may comply with the ability-to-repay rules is limited to certain balloon-payment loans originated by small creditors that operate in predominantly rural or underserved areas. "Small creditors" means those creditors that have less than $2 billion in assets and (together with their affiliates) originate no more than 500 first-lien loans within the scope of the rule per year.

## III. Limitations on Prepayment Penalties

Separate and apart from the ability-to-repay provisions of the new rule, the rule generally prohibits prepayment penalties except for certain fixed-rate, qualified mortgages where the penalties satisfy certain restrictions (e.g., limited to no more than three years after consummation, and do not exceed certain amounts) and the creditor has also offered the consumer an alternative loan without prepayment penalties.

## IV. Further Information

Please note that this advisory is an overview of the final rule, and does not address all aspects and details of the rule. Creditors will need to carefully review the final rule in order to determine what changes may be needed to policies, procedures, and systems.

As noted above, the rule is effective on January 10, 2014. If you have any questions regarding the rule, please feel free to contact Joseph D. Simon at 516-357-3710 or via email at jsimon@cullenanddykman.com.

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