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CFPB "Ability-to-Repay" Standard

An analysis of the Consumer Financial Protection Bureau's Ability-to-Repay and "Qualified Mortgage" rule

January 2013 – A joint point of view by PwC's Financial Services Regulatory Practice and Consumer Finance Group

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Overview of the rule

On January 10, 2013, the Consumer Financial Protection Bureau (CFPB or Bureau) issued its much anticipated final "Ability-to-Repay" rule.[1] Lenders have 12 months to implement the new requirements, which become effective January 10, 2014.

The new rule implements sections 1411, 1412, and 1414 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank). The final rules set out in detail Dodd-Frank amendments to the Truth in Lending Act (TILA) that require mortgage lenders to make a reasonable and good faith determination that a consumer is able to repay the loan according to its terms before offering a loan. It specifies that lenders must consider eight identified underwriting factors, and must verify income and other information considered. Other provisions of the rule limit the ability of mortgage lenders to offer mortgages that include prepayment penalties, establish recordkeeping requirements, and prohibit evasion of the rule.

Violations of the Ability-to-Repay rule are enforceable by the CFPB or by aggrieved borrowers. For example, a borrower can bring an action against a lender within three years of an Ability-to-Repay rule violation or can assert a violation as a defense to foreclosure without any limitation on time. The rule, however, reduces the risk that a borrower will be successful in such action or defense by providing that a mortgage lender or assignee is presumed to have met the Ability-to-Repay requirement if the loan is a "qualified mortgage" (QM). The new rule establishes the definition of "qualified mortgage" and specifies two levels of presumptions of compliance: (1) a safe harbor; and (2) a rebuttable presumption for higher-priced loans.

The final rules are part of a wave of new CFPB rules that implement Dodd-Frank mortgage reform provisions, which will generally become effective in January 2014. This includes rules affecting servicing, originator qualifications and compensation, appraisals, high-cost mortgages, counseling requirements, escrow, and integrated TILA and RESPA mortgage disclosures (which will likely become effective later in 2014).

This wave will likely test the resilience of mortgage market participants. Adapting to these new rules will likely require extensive review and revision of existing policies, procedures, and practices, as well as a review and reconsideration of the economic, strategic, and other assumptions underlying firms' business models.

[1] http://files.consumerfinance.gov/f/201301_cfpb_final-rule_ability-to-repay.pdf.

Summary of key provisions

The final rule is extensive (over 800 pages of text) with many details that warrant careful evaluation. To provide some initial insights into the final rule, we summarize the key provisions, describe some specific steps lenders can take to adapt to the new rule, and note some initial views on potential impacts of the rule, including the following:

- Future product offerings will likely be aligned with the degrees of legal certainty related to non-QM vs. QM loans, and safe harbor and rebuttable presumption QM loans.
- Risk based pricing will likely incorporate different legal certainty and potentially different liquidity related to non-QM vs. QM loans, and safe harbor and rebuttable presumption QM loans.
- There may be challenges to pricing for appropriate risk-based returns for different products given points and fees limits for QM loans and interest-rate constraints for safe harbor treatment (which includes originator compensation and affiliate revenues).
- There may be changes in competitive/industry dynamics based upon differences in how the rule affects across competitors and the requirements for QM treatment may change the relative attractiveness of GSE vs. FHA/GNMA guarantee execution (short and longer term).

Ability-to-Repay standards

Under Dodd-Frank, creditors may not make a residential mortgage loan unless they make a reasonable and good faith determination that the consumer has a reasonable ability to repay the loan. Under the new rule, a lender can meet this Ability-to-Repay requirement by considering, at a minimum, the following eight underwriting factors:

(1) Current or reasonably expected income or assets;

(2) Current employment status;

(3) The monthly payment on the covered transaction;

(4) The monthly payment on any simultaneous loan;

(5) The monthly payment for mortgage-related obligations;

(6) Current debt obligations, alimony, and child support;

(7) The monthly debt-to-income ratio or residual income; and

(8) Credit history.

In addition, lenders must rely on “verified and documented information,” and must verify a consumer’s income or assets relied on using a consumer’s tax return or “third-party documents” that provide reasonably reliable evidence of the consumer’s income or assets.

Potential impact

Lenders will likely need to develop and/or modify policies, procedures, and oversight/controls to comply with the new standards. For example, lenders will need to ensure that they comply with the new underwriting standards; that they document their compliance; and that documentation of that compliance will be sufficient and available throughout the life of the loan.

More immediate impacts of "verified and documented information" requirement include effectively eliminating any remaining mortgage products based on reduced or no-documentation requirements, (e.g., "no doc," "low doc," or "stated income" loans). Other impacts may include potential increases in the time and cost of underwriting mortgages, and potentially making credit less available for borrowers whose circumstances do not fit neatly within the new underwriting requirements (e.g., self-employed borrowers unable to document their income).

Consequences of violations of the Ability-to-Repay rule

Violations of the Ability-to-Repay rule are enforceable by the CFPB through its administrative enforcement authority, e.g., its authority to impose cease-and-desist orders or to impose civil money penalties to address violations of laws or regulations. Significantly, violations of the Ability-to-Repay rule are also enforceable by borrowers by way of a private right of action against a lender or a defense to foreclosure under Dodd-Frank amendments to TILA

Private right of action – The Dodd-Frank Act amended TILA to provide that a borrower can bring an action against a lender for a violation of the Ability-to-Repay rule.[2] Recoverable damages can include: (1) special statutory damages equal to the sum of all finance charges and fees paid by the consumer, unless the creditor demonstrates that the failure to comply is not material; (2) actual damages; (3) statutory damages in an individual action or class action, up to a certain threshold; and (4) court costs and attorney fees that would be available for violations of other TILA provisions. A borrower must bring such an action within three years of the violation.

Defense to foreclosure – TILA, as amended by the Dodd-Frank Act, also provides that when a creditor, or an assignee, other holder or their agent initiates a foreclosure action, a consumer may assert a violation of the Ability-to-Repay rule "as a matter of defense by recoupment or setoff."[3] The amount of special statutory damages included in the recoupment or setoff can be up to three years of finance charges and fees. There is no time limit on the use of this defense.

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[2] Dodd-Frank Act, § 1416 (TILA, § 130(a)).

3 Dodd-Frank Act, § 1413 (TILA, § 130(e)).

Summary of key provisions

Potential impact

The potential for large damages in a borrower action for a violation of the Ability-to-Repay rule and the ability of borrowers in foreclosure to assert a violation of the Ability-to-Repay rule as a defense means that this new rule will likely have a substantial impact throughout the life cycle of a mortgage. Developing reliable processes to ensure compliance, and to maintain documentation evidencing compliance, will necessarily be an area of focus for originators, servicers, and investors.

Definition of "Qualified Mortgage"

A mortgage lender or assignee is presumed to have met the Ability-to-Repay requirement if the loan is a "qualified mortgage." To be afforded treatment as a "qualified mortgage," the final rule specifies that the mortgage and lender 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 verification.** The lender must verify borrower income.
- **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 lender) 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.
- **QM underwriting standards**
  - The lender 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 total ("back-end") 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 the Federal National Mortgage Association (Fannie Mae) or the Federal Home Loan Mortgage Corporation (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 qualified mortgages if it otherwise meets the QM requirements.

Potential impact

Portfolio lenders and investors may seek to reduce the level of potential risk of borrower actions and defenses based on violations of the Ability-to-Repay rule by limiting mortgage products offered or purchased to those that qualify for QM treatment.

The cap on points and fees, and what the rule considers to be points and fees covered by that cap, may cause lenders to reassess their business models. That reassessment may include consideration of how they compensate originators and their affiliates. As we describe below, at the same time the CFPB issued the final rule, it concurrently proposed some interpretive guidance on how originator compensation should be treated under the rule, and requested comments more broadly in this area, which suggests that the CFPB's thinking on this issue may not yet be fully settled. The cap on points and fees may also affect the ability to price for appropriate risk-based returns for different products.

The absence of negative-amortization and interest-only products could make it more difficult for borrowers to maximize the size of the mortgage for which they can qualify based on their current income, potentially keeping more would-be homeowners in the rental market or buying lower priced homes.

The temporary exception from the debt-to-income ratio cap for mortgages eligible for purchase by Government Sponsored Enterprises (GSEs) and certain government agencies appears to give those entities the benefit of QM treatment, without requiring them to make any changes to debt-to-income ratio requirements under their underwriting standards. This may help to prolong the substantial role they currently play in the mortgage market.

QM presumptions of compliance

One of the biggest issues facing the CFPB was whether to structure the QM presumption as a legal safe harbor or a rebuttable presumption of compliance. The final rule provides for a two-pronged approach based on the interest rate of the loan. For higher-priced loans, satisfying the QM operates as a rebuttable presumption; other QMs fall within the legal safe harbor.

- **QM safe harbor.** For a QM to fall within the safe harbor, it must meet all of the qualifications for a QM and have an interest rate that 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 loan.

In this case, a borrower's action or defense to foreclosure based on a violation of the Ability-to-Repay rule is limited to challenging whether the mortgage was in fact a QM with an interest rate within the limits noted above.

- **Higher-priced QM rebuttable presumption.** A QM is considered to be a "higher-priced" QM that is entitled to a rebuttable presumption if it meets all of the qualifications for a QM and has an interest rate that is:

  – Greater than 1.5 percentage points over the APOR for a first-lien loan, or

  – Greater than 3.5 percentage points over the APOR for a subordinate-lien loan.

  Under the rebuttable presumption, a lender that has complied with the enumerated minimum underwriting standards in the rule is presumed to have complied with the Ability-to-Repay rule. A borrower can rebut that presumption by raising specific facts that demonstrate that, based on information of which the lender was aware at origination, the consumer's income and debt obligations at that time left insufficient income or assets to meet living expenses. The CFPB notes that the longer a borrower has made timely monthly payments, the less the borrower will be able to rebut the presumption.

Potential impact

The QM presumptions provide different levels of protection from the risk of borrower actions or foreclosure defenses based on allegations of Ability-to-Repay rule violations, but they also permit different levels of pricing for the risks associated with each type of mortgage. It remains to be seen how portfolio lenders and investors will value the difference between a conclusive presumption safe harbor and a rebuttable presumption, and whether the interest-rate constrains in the rule will provide enough flexibility for lenders and investors to price for appropriate risk-based returns for different products.

Significantly, the interest-rate threshold does not contain any exceptions for jumbo loans or small-balance loans, which may create challenges to their qualifying for safe harbor QM status, which could have adverse impacts on those segments of the mortgage markets.

Summary of key provisions

Qualified Mortgage vs. “Qualified Residential Mortgage”

“Qualified mortgage” under the new CFPB rule and “qualified residential mortgage” (QRM) under a rule proposed by six Federal agencies (not including the CFPB) are similar and related, but are not the same.

The QM and QRM definitions arise from different parts of the Dodd-Frank Act, and they were established for different purposes.

- The purpose of the QM definition is to identify a type of mortgage for which there is a low risk that the lender will have failed to adequately determine the ability to repay before extending the loan.
- The purpose of the QRM definition is to identify a category of mortgage loans that poses a sufficiently low level of credit risk to make it unnecessary to require the issuers of a security collateralized by such mortgages to retain a 5 percent interest in those mortgages. Dodd-Frank generally requires securitizers to retain an economic interest in the credit risk in securitizations (e.g., to retain “skin in the game”).

Potential impact

Under Dodd-Frank, the definition of QM sets the minimum standard on what can qualify as a QRM. Therefore, mortgages with features that disqualify them from treatment as a QM (e.g., interest-only, negative amortization, terms greater than 30 years, or fees and points greater than specified thresholds) cannot qualify for treatment as a QRM. As a result, such mortgages should be subject to the 5 percent interest-retention requirement when the final QRM rule is issued, which may further diminish their presence in the mortgage market.

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 and must reduce consumers’ monthly payments.

The exemption applies only where the refinancing materially reduces the borrower’s monthly payments and where the lender 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 lender holds both the original non-standard 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.

Potential impact

This exception removes consideration of potential liability for violations of the Ability-to-Repay rule as a potential obstacle to lenders engaging in refinancing loans from their portfolio that could prevent borrower defaults, shortly after a non-standard mortgage is recast.

Prepayment penalties

By implementing Dodd-Frank provisions, 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) and the creditor has also offered the consumer an alternative loan without prepayment penalties.

Potential impact

This provision of the rule will limit both the mortgage products that can include prepayment penalties as well as the specific terms of prepayment penalty provisions, when they are permitted.

Record retention

The rule establishes a three-year retention period for records that evidence compliance with the Ability-to-Repay and prepayment penalty provisions.

Potential impact

Lenders should review their record retention policies and procedures against this standard. However, because of the need to retain documentation sufficient to support a presumption of compliance in response to a borrower action or defense to foreclosure, there will be business reasons to retain records for much longer than three years.

Proposed interpretations on calculation of originator compensation

The CFPB recognized that there may be instances in which points or fees that form compensation for a loan originator could inappropriately be double-counted in the points and fees thresholds for QM treatment. In light of that possibility, the Bureau proposed three CFPB interpretations (“comments”) to specify accounting methods where loan originator compensation could otherwise be counted twice under the applicable provision of Dodd-Frank.

The first two proposed CFPB comments provide that:

- A payment from a consumer to a mortgage broker need not be counted toward points and fees twice, where it is reflected both as part of the finance charge and loan originator compensation.
- TILA's requirement to disclose fees and points does not require a creditor to include payments by a mortgage broker to its individual loan originator employee in the calculation of points and fees.

The third proposed comment includes two alternatives:

- The first explicitly precludes offsetting, in accordance with the statute's additive language, by specifying that TILA's disclosure requirement for fees and points requires a creditor to include compensation paid by a consumer or creditor to a loan originator in the calculation of points and fees in addition to any fees or charges paid by the consumer to the creditor.
- The second alternative allows all consumer payments of up-front fees and points to offset creditor payments to the loan originator by requiring a creditor to reduce the amount of loan originator compensation included in the points and fees calculation disclosed as points or fees by any amount paid by the consumer to the creditor and included in the points and fees calculation and disclosed as mortgage broker compensation.

The CFPB seeks comments on all aspects of the proposed CFPB comments, and alternatives, and on any other scenarios that may require clarifying comments to prevent inappropriate double-counting or other unintended consequences.

Potential impact

Because points and fees comprise a critical element of whether a mortgage qualifies for QM treatment, the nuances of how they are computed can be of critical importance. The fact that the CFPB is proposing its interpretations in this area, and is seeking comments more broadly in this area, highlights the CFPB's recognition of the importance of the details of that computation and the CFPB's interest in continuing to receive more industry input into this area. This creates an opportunity for industry participants to have concerns in this area addressed prior to the January 2014 effective date.

Summary of key provisions

Proposed amendments to the final rule

Concurrent with the issuance of the new Ability-to-Repay rule, the CFPB has issued other proposed amendments, including proposed changes to address impacts on community-focused lending programs and homeownership stabilization and foreclosure prevention programs, federal agency refinancing programs, or GSE refinancing programs. The CFPB also proposes special QM requirements for small creditors, and proposes safe harbor treatment for certain higher-priced balloon-payment QMs for lenders operating predominantly in rural or underserved areas that would otherwise qualify only for a rebuttable presumption.

Potential impact
The CFPB has issued the proposal to mitigate potential adverse impacts on the availability of credit for low- and moderate-income borrowers, and to tailor the rule to the capabilities and business model of smaller creditors, including credit unions and community banks.

What can you do now?

While the new rule is not effective until January 2014, lenders should immediately begin to assess the potential strategic and operational impacts the new requirements. This includes, for example, the following:

- **Strategy.** Lenders should consider evaluating the need to optimize their risk-reward balance under the new regulatory environment. For example, they may want to reassess mortgage products and their associated credit risk and revenue/cost structure, compliance risk tolerances, affiliate relationships, and competitive impacts. Some may take a very deep dive into the practical difference in risk profile resulting from falling within the QM safe harbor versus relying on the rebuttable presumption, and determine whether the difference in risk is over- or under-reflected by the market and whether there are certain products that may need to be retired as falling outside of risk tolerance levels.

  Lender's may:

  - Align offerings/purchases to the requirements for safe harbor or rebuttable presumption QM treatment and to other CFPB and other regulatory issuances (e.g., the definition of "qualified residential mortgage" for purposes of the proposed securitization risk-retention rule).
  - Refocus any new product efforts on developing products that stay within the boundaries of QM treatment.
  - Consider opportunities afforded for certain refinancing.

- **Products, pricing and fee structure.** A lender's products, pricing and fee structure should be aligned with the new rule and the organization's business model and risk appetite. Products, pricing and fee structures should be evaluated to determine what, if any, changes might be necessary to support treatment as a safe harbor or rebuttable presumption QM and otherwise comply with the new rule. For example, lenders should consider:

  - How they are impacted by requiring income verification and the elimination of "no doc," "stated income," and similar loans from the permissible product mix.
  - Whether competitive pricing comparisons and analytics should be modified.
  - How to adjust compensation agreements to align with the new rules for all channel lines (retail, wholesale, and correspondent).
  - Whether they need to make changes to loan pipeline fall-out assumptions and loan-level pricing adjustments (LLPAs) that may result from changes in credit quality assumptions.

Summary of key provisions

Sales and fulfillment. Lenders will likely want sales and origination staff to be well trained and knowledgeable before they offer or fulfill mortgage products, apply underwriting standards, and price loans, to ensure alignment with the Ability-to-Repay rule as well as the organization's business model and risk appetite. Lenders should review and revise loan origination and underwriting policies and procedures, and systems and controls to ensure adherence with Ability-to-Repay and QM requirements. Lenders and servicers should also review their loan processing systems to ascertain their ability to detect unallowable or limited documentation of income, fees and points, and to ascertain the validation of underwriting standards to Ability-to-Repay requirements.

Servicing. A presumption of compliance may not reduce risk of borrower actions or defenses to foreclosure unless the servicing function provides ready access to origination documentation that can demonstrate compliance with the Ability-to-Repay requirements or QM standards at the time of foreclosure. As necessary, lenders will need to review and modify the handoff procedures from origination to servicing as well as servicing systems, policies, and procedures to ensure that mechanisms are in place to benefit from the maximum presumption to which it is entitled by law.

Reporting requirements. Lenders, servicers, and investors may want to consider strengthening reporting metrics to identify loans that meet the safe harbor or rebuttable presumption QM standard and to identify third-party originations and/or internal operations that fail to comply with the QM standards. Enhanced reporting could be applied to trigger root cause analyses and corrective action plans as necessary.

Conclusion

The new Ability-to-Repay rule and the other new CFPB rules on mortgage activities will have substantial impacts on the mortgage industry and will likely test the resilience of all mortgage market participants. Based on the assistance we have provided to mortgage participants, we believe that firms that demonstrate the most resilience in adapting to significant new requirements are those that leverage existing, in-house, company-specific expertise by drawing on support from external advisors with broad expertise in the origination activities and risk processes across the industry. Essentially, firms achieve the most effective results by combining their current strength in what they do well, with leading practices or methods they can use to enhance areas where challenges may be greatest and/or where challenges are not well addressed by their strengths.

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