CPFB Finalizes Amendments to Rules Governing Ability-to-Repay and Qualified Mortgages

Executive Summary

The Bureau of Consumer Financial Protection ("CFPB" or "Bureau") released a final rule on May 29, 2013 that amends its January 2013 final rule implementing the Ability-to-Repay (ATR) and Qualified Mortgage (QM) provisions of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the "Dodd-Frank Act"). The amendments (the May Final Rules), which were originally proposed concurrently with the January 2013 final rule (ATR Rules): exempt certain nonprofit creditors and certain homeownership stabilization programs from the ATR Rules; add a new QM category for certain loans made and held in portfolio by small creditors; and, change the calculation of loan originator compensation that must be included in "points and fees" under the ATR Rules. Notable highlights of the May Final Rules include the following:

- The CFPB withdrew the proposed exemption from the ATR Rules for credit extended as a refinancing that is eligible to be insured, guaranteed or made pursuant to a program administered by the Federal Housing Administration, U.S. Department of Veterans Affairs, or the U.S. Department of Agriculture, or that is eligible to be purchased or guaranteed by Fannie Mae or Freddie Mac (the GSEs).
- The CFPB amended the calculation of loan originator compensation to exclude compensation paid by a consumer to a mortgage broker when that payment has been included in points and fees, as well as compensation paid by creditors and mortgage brokers to their employees.

The May Final Rules become effective on January 10, 2014 along with the ATR Rules.

Background

The CFPB's ATR Rules amend Regulation Z, which implements the *Truth-in-Lending Act* (TILA), to implement Sections 1411, 1412 and 1414 of the Dodd-Frank Act. These provisions generally prohibit a creditor from making certain residential mortgage loans unless the creditor makes a reasonable and good faith determination, based on verified and documented information, that the consumer will have a reasonable ability to repay the loan, including any mortgage-related obligations (such as property taxes). The final rule also establishes certain creditor protections from liability for mortgages meeting the definition of a QM that are not "higher-priced mortgages" (as defined in the rule), as well as a rebuttable presumption for "higher-priced mortgages" that otherwise meet the QM standards. Please refer to Regulatory Practice Letter 13-05 for additional information.

Description

Exemptions

The Bureau has finalized amendments to the ATR Rules that exempt the following extensions of credit from the ATR requirements:

- Credit extended pursuant to a community-focused lending program, including extensions of credit made by a:
  - Community Development Financial Institution
  - Downpayment Assistance Provider of Secondary Financing
  - Community Housing Development Organization that meets certain requirements
  - Tax exempt entity that:
    - In the preceding calendar year, extended no more than 200 loans (an increase from the proposed 100 loan limit), secured by a dwelling;
    - In the preceding calendar year, extended credit only to consumers with income that did not exceed the qualifying limit for moderate income families;
    - Is extending credit to a consumer with income that does not exceed the household limit in the ATR Rules; and
    - "Determines, in accordance with written procedures, that the consumer has a reasonable ability to repay the credit." (The written procedures and reasonability to repay criteria would be established by the creditor.)
- Credit extended pursuant to an *Emergency Economic Stabilization Act* ("EESA") program.

The Bureau determined <u>not</u> to finalize the proposed exemption for credit extended as:

- A refinancing eligible to be insured, guaranteed, or made pursuant to a program administered by the Federal Housing Administration, U.S. Department of Veterans Affairs, or the U.S. Department of Agriculture; or
- A refinancing that is eligible to be purchased or guaranteed by Fannie Mae or Freddie Mac.

Small Creditors

The May Final Rules adopt, substantially as proposed, a new category of Qualified Mortgage for certain loans originated by small creditors (i.e., those that have total assets of $2 billion or less at the end of the previous calendar year and together with all affiliates originated 500 or fewer first-lien covered transactions during the previous calendar year). The new category includes only loans held in portfolio for at least three years, subject to limited exceptions that include, among others, loans originated subject to a forward commitment to a creditor that also meets the assets and lending limits for a small creditor. In addition, the loans must conform to all of the requirements under the general definition of a QM except the 43 percent limit on the monthly debt-to-income ratio. For this QM category, the small creditor need not operate predominantly in rural or underserved areas.

For this QM category, a "higher-priced mortgage loan" is defined as a loan with an annual percentage rate (APR) that exceeds the average prime offer rate (APOR) by more than 3.5 percentage points for both a first-lien and a second-lien mortgage.

Balloon-Payment Qualified Mortgages

For small creditors operating predominantly in rural or underserved areas, the May Final Rules adopt the proposal to permit the creditor to offer balloon-payment QMs (under the exemption provided in the ATR Rules) with an APR that exceeds the APOR by 3.5 percentage points and still benefit from a conclusive presumption of compliance with the ability-to-repay rules or "safe harbor" (which is otherwise subject to a threshold of 1.5 percentage points over the APOR).

The May Final Rules add a temporary provision to permit small creditors that do not operate in predominantly rural or underserved areas a two-year transition period to offer balloon-payment QMs to be held in portfolio. These loans would also be subject to the threshold of 3.5 percentage points over the APOR.

Loan Originator Compensation

The May Final Rules exclude from the calculation of points and fees loan originator compensation paid by a:

- Consumer to a mortgage broker when that payment has already been counted toward the points and fees thresholds as part of the finance charge;
- Mortgage broker to an employee of the mortgage broker; or
- Creditor to its loan officers.

The CFPB suggests these amendments will ensure that "the points and fees calculation is not artificially inflated" by counting a single payment twice in these instances, which was a potential result of the previous "additive" approach that included "all" compensation paid "directly or indirectly" and "from any source."

The provisions requiring a creditor to include in points and fees the compensation paid by the creditor to a mortgage broker, in addition to up-front charges paid by the consumer to the creditor that are included in points and fees, have been retained.

Commentary

The CFPB's ATR Rules present great challenges in adoption and implementation for institutions, mortgage brokers, and correspondent lenders alike, especially with regard to QMs. In lights of these rules, many lenders are reevaluating their product offerings and business strategies with a critical examination of their product mix (e.g., should they offer only QMs) the investment/securitization market, and servicing options. It is important to remember, though, that on the surface QMs are loans that meet a set of guidelines (rules) that enable a lender to fall under a presumption that the consumer has an ability to repay the mortgage. Lenders are not required to originate according to QM guidelines and there may be other methods that lenders can establish as their own guidelines regarding ability to repay that could meet the requirements of the rule. A key issue will be documenting a determination of ability-to-repay using verified and documented information.

That said, there are a number of areas that should be considered. For instance:

- The CFPB indicates that it withdrew the proposed exemption for refinancing loans eligible for purchase or guarantee by the GSEs because it "would be inappropriate." The CFPB states the QM provision, "which generally provides qualified mortgage status to loans that are eligible for purchase, insurance, or guarantee by the specified Federal agencies, including refinancing, strikes the appropriate balance between preserving consumers' rights to seek redress for violations of TILA and ensuring access to responsible, affordable credit during the current transition period." The expansion of the QM to these loans is temporary for up to seven years or until the GSEs issue separate rules to define a qualified mortgage.

- The GSEs (Fannie Mae and Freddie Mac) will be issuing QM eligibility and underwriting guidelines under the direction of FHFA. This action will create one set of standards for mortgage originations that cover conforming loans. Lenders following the GSE QM guidelines do not have to sell those loans to the GSEs to gain the QM presumption though it is likely that most lenders will want to ensure they have the ability to originate GSE-conforming loans according to the guidelines issued by the GSEs.
- In advance of the release of GSE QM guidelines, the GSEs have stated they will rely on lender representations and warranties (R&Ws) to manage QM adherence. Also, in late 2012, the GSE's announced limits on R&Ws, placing a 36 month enforcement window in many cases. The current R&W environment and the associated repurchase risk, creates several implications for lenders and GSE's alike. Clearly, lender quality control (QC) continues to be important to confirm the lender's assessment that a loan meets QM requirements. It is likely the GSEs will continue or enhance QC diligence for new loans, especially given the shorter time frames to issue a potential repurchase demand. This could create friction in the process if defects are revealed as loans are presented for purchase to the GSEs. The need for QC systems to quickly and accurately evaluate loans is increasingly important. Finally, the need for independent oversight of the QC function is an important governance consideration.
- There are certain complexities related to establishing QM compliance. In addition to the prescriptive components – such as 43 percent backend ratio, income calculation, etc., there are other areas where the requirements are not as prescriptive and must be established by the lender – such as the front-end ratio, minimum down payment, maximum loan-to-value ratio, and credit characteristics such as credit history and credit score thresholds. Additionally,
  - Many otherwise qualified borrowers may potentially fall outside of the 43 percent backend ratio. Lenders will need to seek out ways to make loans to non-QM borrowers using multiple risk layers, or compensating factors, to determine the quality of a loan. As risks are more clearly defined, investors and securitization participants will likely look to build markets for these borrowers.
  - Income calculations, especially those for self employed borrowers, can be complex and require underwriter judgment. Also, documentation of income and other key elements of the loan have traditionally lacked standardization, as many lenders have disparate systems and documentation capabilities. Given the lack of standardization, the data underlying the documents also, traditionally lack transparency and portability. To create more transparency and the ability to determine QM acceptance, the industry may adapt new standards. Central to this is the FHFA-required Uniform Mortgage Data Program (UMDP) and the industry standards body Mortgage Industry

Standard Maintenance Organization or MISMO. The recent GSE appraisal program, Uniform Collateral Data Portal (UCDP) and the associated Uniform Appraisal Dataset (UAD) is likely the first of a comprehensive set of data and document standardization programs. Lender operational changes will likely continue and accelerate as a means to creating needed standardization.

- The amendments to the loan originator compensation calculation may relieve some concerns in the industry related to the points and fees threshold of the QM standard and the potential for double-counting.

To reiterate from our earlier release (RPL 13-05) - In preparation for the January 10, 2014 effective date, institutions should revisit their policies, procedures and internal controls to ensure those related to the determination methods and documentation requirements of ability to pay, and the Qualified Mortgage standards, as appropriate, have been met. Institutions and other mortgage originators will also need to consider and address through their procedures, policies and controls, the differences in underwriting and eligibility requirements (or standards) among QMs, Qualified Residential Mortgages (QRMs) rules when they are issued (due out this year to address risk retention for securitized mortgage loans), the GSEs' alternatives to Qualified Mortgages when they are issued, as well as other investor guidelines.

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