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Mortgage Underwriting - The Qualified Mortgage and Ability to Repay Rules

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The Consumer Financial Protection Bureau (CFPB) recently sought additional comment on its proposed rule on the definition of a "qualified mortgage" and ability to repay requirements mandated by the Truth in Lending Act (TILA), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The CFPB is considering adding a specific DTI ratio requirement to the "qualified mortgage" definition and still has not determined whether to structure the rule so as to provide a safe harbor for lenders originating "qualified mortgages."

The Issue: The Dodd-Frank Act amended TILA to prohibit lenders from originating mortgage loans without verifying the borrower's ability to repay the loan based on the following eight borrower characteristics: (1) current or reasonably expected income or assets; (2) current employment status; (3) the monthly payment on the mortgage; (4) the monthly payment on any simultaneous loan; (5) the monthly payment for mortgage-related obligations; (6) current debt obligations; (7) the monthly debt-to-income ratio, or residual income; and (8) credit history.

The Dodd-Frank Act creates special rights and defenses for borrowers whose lenders have failed to verify ability to repay pursuant to the above criteria, including bringing a private cause of action for damages (including for all finance charges and fees paid by the borrower) within three years from origination of the mortgage and also as a defense to foreclosure at any time during the life of the loan.

A lender is presumed to have complied with the ability to repay requirements, however, where it originates so-called “qualified mortgages.” The CFPB is considering two alternative definitions of what constitutes a “qualified mortgage,” one of which would create a safe harbor for lenders originating loans without certain features, and another which would instead create a presumption of compliance if certain criteria are met but which the borrower could rebut with evidence. The distinction is key, as qualification for the safe harbor would be based on a limited number of borrower characteristics, whereas qualification for a rebuttable presumption could be based on a broader set of more loosely defined criteria.

DTI Ratio Requirement. The CFPB has indicated that it is considering whether analysis of loan level data -- particularly how certain loan characteristics correlate with loan performance over time -- may enable it to identify a specific Debt-To-Income ratio (DTI) below which a lender can be presumed to have established a borrower’s ability to repay his or her mortgage.

Under the safe harbor version of the proposed “qualified mortgage” definition, a lender would be shielded from liability and protected from foreclosure defenses where the mortgage (1) does not contain negative amortization, interest-only payments, or balloon payments, or a loan term exceeding 30 years; (2) the total points and fees do not exceed 3% of the total loan amount; (3) the borrower’s income or assets are verified and documented; and (4) the underwriting of the mortgage (a) is based on the maximum interest rate in the first five years, (b) uses a payment schedule that fully amortizes the loan over the loan term, and (c) takes into account any mortgage-related obligations.

Under the alternative version of the proposed “qualified mortgage” definition, a rebuttable presumption in favor of the lender would be created whereby the lender is presumed to have satisfied the ability to repay requirements if it satisfies the aforementioned safe harbor criteria as well as the following additional underwriting requirements from the ability to repay standard: (1) the consumer’s employment status, (2) the monthly payment for any simultaneous loan, (3) the consumer’s current debt obligations, (4) the total debt-to-income ratio or residual income, and (5) the consumer’s credit history.

In considering a specific DTI ratio as a component of the “qualified mortgage” definition, the CFPB is departing from its position in the original notice of rulemaking that “such a requirement would not provide certainty that the loan is a qualified mortgage” because of “the discretion inherent in making these calculations.”

Per its notice reopening the comment period on the proposed rule, the CFPB proposed to use mortgage loan data it obtained from the Federal Housing Finance Agency (FHFA) -- as well as additional data from public commenters -- to examine the relationship between loan delinquency and variables such as the borrower's DTI ratio, residual income and liquid reserves for purposes of defining what constitutes a "qualified mortgage" that is presumed to have met the ability to repay criteria. The CFPB specifically noted that some commenters on the initial proposed rule requested that it adopt a specific DTI requirement.

The FHFA dataset includes loan level data for loans purchased or guaranteed by the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), and the mortgages in the dataset are all first-lien mortgages that have fully documented income and that are fully amortizing with a maturity that does not exceed 30 years.

The CFPB sought comment on the dataset it received from the FHFA and requested commenters to provide it with additional data to aid the CFPB in its analysis of whether and how DTI ratios and other factors such as liquid reserves correspond to serious loan delinquencies. The CFPB specifically requested additional data for loans not covered in the FHFA data, as well as data showing the relationship between loan performance and a borrower's DTI ratio, residual income and liquid reserves.

Anticipated Litigation Costs Under Alternative Definitions. The CFPB also requested additional data on estimated litigation costs associated with anticipated ability to repay litigation and appears to be comprehensively evaluating how such costs could be expected to differ depending on whether it adopts the safe harbor or rebuttable presumption definition.

The CFPB specifically requested data and comment on (1) how estimates of anticipated litigation costs are affected by what measure of delinquency is used and how best to estimate the number of damages suits brought within the three year statute of limitations but outside the foreclosure context; (2) how such costs would differ under the safe harbor and rebuttable presumption alternatives; (3) what the likely outcomes would be under the safe harbor and rebuttable presumption alternatives, including estimates of average damages based on various loan characteristics; and (4) what other costs should be considered, including the risk that loans are "put back" to originators due to alleged ability to repay violations and extended foreclosure timelines where the ability to repay rules are raised as a defense to foreclosure.

Implication: The CFPB has indicated that it is now considering whether to add a specific DTI ratio requirement to its definition of what constitutes a "qualified mortgage," and it is continuing to analyze anticipated litigation costs in evaluating whether to create a safe harbor for lenders originating "qualified mortgages." The final rule defining the parameters of what constitutes a "qualified mortgage" has potentially far reaching implications for the future of mortgage lending. According to the American Bankers

Association, its members may refrain from originating mortgage loans that do not meet the “qualified mortgage” definition. Mortgage industry groups and consumer advocates have both advocated for a broad definition of what constitutes a “qualified mortgage” so as to avoid an undue restriction in mortgage credit, and the American Bankers Association has urged the CFPB not to exclude mortgage loans from the “qualified mortgage” definition where the DTI ratio is below 50 percent. Because the ability to repay rules provide for a private cause of action regardless of whether the borrower is delinquent (within the first three years from origination), the potential for litigation costs are increased. Moreover, were the CFPB to adopt a rebuttable presumption standard rather than a safe harbor, litigation costs are likely to be greater because it would be more difficult to dispose of lawsuits at the pleadings stage.

The CFPB’s notice of reopening the comment period is available **here.** The original notice of proposed rulemaking is available **here**.

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