

Consumer Financial Protection Bureau Implements “Ability to Repay” Regulations for Covered Mortgage Loans

It is a widely understood that loose underwriting standards and practices by some creditors – including their abject failure in some instances to confirm their borrowers’ ability to repay mortgage loans – contributed in large measure to the mortgage crisis in 2008 that led to the nation’s most serious recession since the Great Depression.

In response to this crisis, Congress enacted several significant pieces of legislation, including the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act). To combat loose underwriting standards, the Dodd-Frank Act included certain ability-to-repay requirements applicable to virtually all closed-end residential mortgage loans, which were adopted primarily as amendments to the Federal Truth in Lending Act (the TILA). The Dodd-Frank Act amendments to TILA also contained presumptions of compliance with the ability-to-repay standard for certain qualifying mortgage loans.



By David J. Mack

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In January 2013, the Consumer Financial Protection Bureau (the Bureau), which is the agency granted authority for the enforcement of TILA, adopted regulations implementing the ATR/QM provisions of the Dodd-Frank Act. The new regulations generally apply to closed-end consumer credit transactions that are secured by a dwelling for which a lender has received an application on or after January 10, 2014. This article provides a brief overview of the newly implemented “Ability to Repay” (ATR) regulations adopted by the Bureau and incorporated into Regulation Z (12 CFR Part 1026).

General Requirement of the ATR Regulations

The ATR regulations require that lenders make a reasonable, good-faith determination before or when they consummate a mortgage loan that the consumer has a reasonable ability to repay the loan. In doing so, they must consider such factors as the consumer’s income or assets and employment status (if relied on) against:

- The mortgage loan payment;
- Ongoing expenses related to the mortgage loan or the property that secures it, such as property taxes and insurance;

- Payments on simultaneous loans that are secured by the same property; and
- Other debt obligations, alimony, and child-support payments.

The regulations also require lenders to consider and verify the consumer's credit history. The general ATR standard does not ban any particular loan features or transaction types, but a particular loan to a particular consumer is not permissible if the creditor does not make a reasonable, good-faith determination that the consumer has the ability to repay. Thus, the purpose of the regulations is to ensure that underwriting practices are sound and reasonable.

The regulations provide certain presumptions that a lender has complied with the ATR regulations with respect to a loan when the loan in question satisfies the standards for a "Qualified Mortgage" (QM). While lenders are not required to underwrite loans that meet the heightened QM requirements, a loan that does is granted a legal presumption that it satisfies the ATR requirements in the event it's been challenged by the borrower. To qualify for the presumption, QMs generally must satisfy certain specific underwriting criteria, cannot contain certain risky features (such as allowing interest-only payments or negative amortization), and the ability to charge points and fees on QMs is limited.

Transactions covered by the ATR/QM Regulations

The Bureau's ATR/QM regulations apply to almost all closed-end consumer credit transactions secured by residential structures that contain one to four units (including condominiums and co-ops) and any real property attached to the dwelling. Unlike some other mortgage rules, the ATR/QM regulations are not limited

to first liens or to loans on primary residences. However, some specific categories of loans are excluded from the regulations. Specifically, they do not apply to:

- Open-end credit plans (principally, home equity lines of credit, or HELOCs);
- Time-share plans;
- Reverse mortgages; and
- Temporary or bridge loans with terms of 12 months or less (with possible renewal).

Potential liabilities for making loans outside the restrictions of the ATR/QM Regulations

The Dodd-Frank Act amended the TILA to create special remedies for violations of the ATL provisions. As amended, TILA provides that a consumer who brings a timely action against a creditor for a violation may be able to recover 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. This recovery is in addition to: (1) actual damages; (2) additional statutory damages; and (3) court costs and attorney fees that would be available for violations of other TILA provisions. The statute of limitations for a violation of the ATL provisions is three years from the date of the occurrence of the violation (as compared to one year for most other TILA violations).

In addition, the TILA also now provides that when a creditor initiates a foreclosure action, a consumer may assert a violation of the ATL requirements as a matter of defense by recoupment or setoff, which defense is generally limited to no more than three years of finance charges and fees.

Importantly, the ATR determination applies to information known by the

lender at or before the consummation of the loan transaction. The Bureau has indicated, for example, that a financial institution will not be in violation of the ATR requirements if consumers cannot repay their mortgage loans solely because they experienced a sudden and unexpected job loss after the origination of the loan.

The Eight ATR Underwriting Factors

A reasonable, good-faith ATR evaluation must include an analysis of the following eight ATR underwriting factors:

1. Current or reasonably expected income or assets (other than the value of the property that secures the loan) that the consumer will rely on to repay the loan;
2. Current employment status (if the lender relies on employment income when assessing the consumer's ability to repay);
3. Monthly mortgage payment for this loan, calculated by using the introductory or fully-indexed rate, whichever is higher, and monthly, fully-amortizing payments that are substantially equal;
4. Monthly payment on any simultaneous loans secured by the same property;
5. Monthly payments for property taxes and insurance that the consumer is required by the lender to buy, and certain other costs related to the property such as homeowners association fees or ground rent;
6. Debts, alimony, and child support obligations;
7. Monthly debt-to-income ratio or residual income, calculated using the total of all of the mortgage and non-mortgage obligations listed above, as a ratio of gross monthly income; and
8. Credit history.

The regulations do not preclude a lender from considering additional

factors, but it must consider these eight factors at a minimum. The reasonableness and good faith of any credit determination depends on the facts and circumstances relevant to the particular loan at the time of the origination. For example, a particular credit determination may be reasonable and in good faith even though the consumer defaulted shortly after consummation if, for example, the consumer experienced a sudden and unexpected loss of income.

Verification of Information Using Reliable Third-Party Records

Financial institutions must verify the information relied upon using reasonably reliable third-party records. An institution is prohibited from relying on information provided by consumers with respect to their income, etc. which is not verified by a reliable third-party record. Below is a list of some of the types of third-party records deemed by the Bureau to be reasonably reliable for verification purposes, but the Bureau has indicated that this list is not all-inclusive:

- Records from government organizations such as a tax authority or local government;
- Federal, state, or local government agency letters detailing the consumer's income, benefits, or entitlements;
- Statements provided by a cooperative, condominium, or homeowners association;
- A ground rent or lease agreement;
- Credit reports;
- Statements for student loans, auto loans, credit cards, or existing mortgages;
- Court orders for alimony or child support;

- Copies of the consumer's federal or state tax returns;
- W-2 forms or other IRS forms for reporting wages or tax withholding;
- Payroll statements;
- Military leave and earnings statements;
- Financial institution records, such as bank account statements or investment account statements reflecting the value of particular assets;
- Records from the consumer's employer or a third party that obtained consumer-specific income information from the employer;
- Check-cashing receipts; and
- Remittance-transfer receipts.

The Bureau has acknowledged that sometimes a creditor may have to rely upon a self-employed borrower's report of his or her own income. For example, a self-employed borrower may provide a year-to-date income statement to supplement his tax returns from prior years. These records will qualify as reasonably reliable third-party records to the extent that an appropriate third party has reviewed them; such as in instances where the report was prepared or reviewed by a third party accountant.

Qualified Mortgages

As indicated above, the new regulations provide a presumption that any loan satisfying the criteria for a QM also complies with the ATR requirements. Again, lenders are not required to underwrite loans that meet the heightened QM requirements. However, a loan that does satisfy the requirements is granted a legal presumption that the lender has met the ATR requirements in the event the loan has been challenged by the borrower on those grounds. This effectively means that lenders should attempt to satisfy the QM requirements

whenever reasonably possible in order to protect the enforceability of their loans.

QMs have three types of general requirements: (1) restrictions on loan features, (2) points and fees limits, and (3) underwriting standards. One of the principal underwriting requirements for Qualified Mortgages in general is that the borrower's total debt-to-income ratio not be higher than 43%, which is determined pursuant to specific requirements provided in the regulations. Higher risk loan features and practices that are prohibited include negative amortization and interest-only periods and loan terms for periods longer than 30 years. With respect to fees and point restrictions, such points and fees generally may not exceed 3 percent of the total loan amount, but higher thresholds are provided for loans below \$100,000.

The regulations provide four separate classifications of QMs. Two types, the General QM and Temporary QM, can be originated by all lenders. The other two, Small Creditor and Balloon-Payment QMs, can only be originated by institutions that meet the definition of "small creditor."

The regulations provide different degrees of presumption of ATR compliance depending on whether the loan at issue is classified as "higher-priced." Qualified Mortgages under the General and Temporary definitions are considered higher-priced if they have an APR that exceeds the "average prime offer rate" (APOR) by 1.5 percentage points or more for first-lien loans and 3.5 percentage points or more for subordinate-lien loans. Small Creditor and Balloon-Payment QMs are considered higher-priced if they have an APR that exceeds the APOR by 3.5 percentage points or more for both first-lien and subordinate-lien loans.

If a loan that is not categorized as higher-priced and otherwise satisfies the QM criteria, a court will *conclusively presume* that the loan has been made in compliance with the ATR. QMs that are higher-priced only have a *rebuttable presumption* that they comply with the ATR requirements, and consumers have the opportunity to present evidence in court to rebut that presumption.

General QM Loans: In order for a loan to qualify as a General QM loan, the creditor must satisfy the following additional requirements:

- Underwrite based on a fully-amortizing schedule using the maximum rate permitted during the first five years after the date of the first periodic payment;
- Consider and verify the consumer's income or assets, current debt obligations, alimony and child-support obligations; and
- Determine that the consumer's total monthly debt-to-income ratio is no more than 43%, using the definitions and other requirements adopted by the CFPB and included in the regulations.

Temporary QM Loans: For a temporary transitional period, certain loans that are eligible for purchase or guarantee by certain government-sponsored enterprises (GSE) – such as the Federal National Mortgage Association (Fannie Mae), the Federal Housing Administration (FHA) insurance, the U.S. Department of Veterans Affairs (VA), the U.S. Department of Agriculture (USDA), and the Federal Home Loan Mortgage Corporation (Freddie Mac) – will be deemed to be QMs under a temporary definition. The loans must meet certain QM restrictions on loan features and points and fees, but they are not subject to a flat 43% debt-to-income limitation. The temporary provision for loans eligible for insurance or guarantee by

a GSE is a transition measure designed to give those agencies time to exercise separate authority under the Dodd-Frank Act to determine which of their loans will receive QM status. This temporary provision will expire on the date that the relevant agency's own QM rules take effect or on January 10, 2021, whichever occurs first. Loans that receive QM status under the temporary provision will retain that status after the temporary provision expires, but new loans will not receive QM status after that date under the temporary provision.

Loans falling under the Temporary QM definition must meet the same requirements as General QM loans regarding prohibitions on risky features (negative-amortization, interest-only, and balloon-payment features), a maximum loan term of 30 years, and points-and-fees restrictions.

Small Creditor QM Loans: In response to the special concerns of smaller lenders, special provisions have been granted for Qualified Mortgages held in portfolio by small creditors. There are two additional types of QMs that can only be originated by small creditors (Small Creditor QMs and Balloon-Payment QMs). These Qualified Mortgages have a different, higher threshold for when they are considered higher-priced for Qualified Mortgage purposes than other Qualified Mortgages, and they are also not subject to the rigid 43 percent DTI limit applicable to the general standard.

A financial institution will qualify as a “small creditor” if it satisfies both of the following requirements:

- It had assets below \$2 billion (to be adjusted annually for inflation by the Bureau) at the end of the last calendar year; and
- It and its affiliates together originated no more than 500 first-lien, closed-end

residential mortgages that are subject to the ATR requirements in the preceding calendar year.

In order for a loan to be a “Small Creditor” QM loan, the creditor must satisfy the General QM standards except as follows:

- The creditor is still required to consider the consumer's debt-to-income ratio or residual income, but the regulations apply no specific threshold for DTI or residual income as does the standards applicable to General QMs; and
- The creditor must not make the loan subject to a forward commitment (an agreement made at or prior to consummation of a loan to sell the loan after consummation, other than to a creditor that itself is eligible to make Small Creditor QMs). The rationale for this is that the exemption should be available only for loans to be held “in portfolio.” Any loans intended for sale in the secondary market may need to satisfy the General QM standard.

Small Creditor QMs will generally lose their QM status if they are sold less than three years after consummation.

With respect to Balloon-Payment QMs, the Bureau is providing a two-year transition period during which all small creditors can continue to make such loans regardless of the geographic location where the lender operates. After that two-year period expires, only small creditors that operate predominantly in rural or underserved areas will be able to continue to make Balloon-Payment QMs. Like Small Creditor QMs, Balloon-Payment QMs generally lose their QM status if they are sold or otherwise transfer them less than three years after consummation.

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