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The Consumer Financial Protection Bureau's Amendments to the Ability-to-Repay Rule

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The Consumer Financial Protection Bureau (CFPB) recently issued a series of amendments to the Ability-to-Repay rule, which is set to go into effect January 10, 2014. The rule, originally issued in January of this year, holds lenders legally responsible for acting in good faith and making a reasonable determination, before closing, that a homebuyer has a realistic chance of repaying a mortgage loan. The rule will set the tone for the U.S. mortgage market because it places a legal duty on lenders to ensure that a consumer can afford to pay their mortgage. The law will presume lenders have complied with this duty only if they issue qualified mortgage (QM) loans. Because of this presumption, and the increased legal protection it provides, it is expected that almost all lenders will minimize the origination of non-QM loans. The CFPB's amendments to the rule relate directly to the underwriting requirements for qualified mortgages and address:

- How loan originator compensation is to be calculated in determining points and fees;
- The elimination of the 43 percent debt-to-Income ratio for some qualified mortgage loans issued by small lenders;
- Increasing the amount that small lenders may exceed the average prime offer rate from 1.5 percent to 3.5 percent;
- Delaying the phase-out of balloon-payment loans;
- The exemption of government agencies, programs, and credit products from the ability-to-pay rule entirely.

Each amendment is discussed in greater detail on subsequent pages.

I. The amendments clarify how loan originator compensation is to be calculated in determining points and fees.

When the rule was released, there were many concerns about how loan originator compensation would be accounted for in calculating the points and fees for a mortgage and, in particular, that some forms of compensation would be counted twice (double-counting), potentially inflating the real cost to the consumer. The rule states that the calculation of points and fees should include:

> "all compensation paid directly or indirectly by a consumer or creditor to a loan originator that can be attributed to that transaction at the time the interest rate is set."[1]

Double counting would include all compensation as it flows from one party to another, no matter the source. For example, if a consumer pays $1000 in fees to a brokerage, and the brokerage passes along $500 to its employee, under the original rule the total fee could be calculated by adding both the $1000 and the $500, for a total of $1500. The greater the fee total, the less likely a loan could stay within the 3 percent fee cap that exists for qualified mortgages.2 In a comment to the CFPB, NCRC stated that fees should be calculated in a way that ensures they are an accurate reflection of the actual cost to the consumer, without shrinking the number of loans that are eligible for qualified mortgage status. At the same time, NCRC made it clear that cap compensation should include payments to non-employees in order to limit any incentive for abuses based on product steering.

The amended rule does provide clarity on the loan originator fees that are to be included and, with the goal of capturing the real cost to the consumer, eliminates many instances of possible double counting that could artificially inflate points and fees. It also protects consumers from opaque costs, such as yield spread premiums, by retaining double-counting for compensation of non-employees. The fees included in the amended rule are as follows:

1. 12 C.F.R 1026.32(b)(1)(ii)
2. To be a qualified mortgage, the total points and fees must not exceed 3% of the total loan value.

A. What is included in the calculation of points and fees?

a. **Any origination charges paid by a consumer to the creditor.** This is the basic fee and total out-of-pocket expense for the consumer.

b. **Compensation paid by a creditor to a mortgage broker.** This fee is included to discourage mortgage brokers from steering consumers toward more expensive products.

c. **Compensation paid by a consumer or creditor to a loan originator who is not employed by the creditor.** This fee would be included because it is important in determining the total cost to the consumer.

B. What is not included in the calculation of points and fees?

a. **Payments by consumers to mortgage brokers.** These payments need not be counted as loan originator compensation where such payments already have been included in points and fees as part of the finance charge.

b. **Compensation paid by a mortgage broker to its employee loan originator.** The amendment eliminates the possibility of double counting in this instance by counting only the direct payment from the consumer to the creditor, and not the indirect payment of the mortgage broker to the employee.

c. **Compensation paid by a creditor to its loan originator employees.** Money passed along that was part of the original fee is not included so long as the recipient is an employee of the loan originator.

In general, the CFPB's method for calculating points and fees strikes a balance between the needs of consumers and industry. NCRC supports these amendments, but encourages the CFPB to continue monitoring the distribution of fees to ensure that loan originators are complying with both the letter and spirit of the regulation.

II. The amendments eliminate the 43 percent debt-to-income ratio for some qualified mortgage loans issued by small lenders.

Both lenders and consumer advocates raised concerns that the 43 percent debt-to-income ratio requirement for qualified mortgages could be overly restrictive. NCRC believes that the 43 percent debt-to-income requirement does not acknowledge the many consumers with much greater debt-to-income ratios who have successfully managed to become and remain homeowners. NCRC is also concerned that the restrictiveness of a 43 percent to debt-to-income ratio will limit the availability of mortgage capital to a number of creditworthy individuals living in high-cost underserved communities. Community-based lenders, small lenders, and small creditors[1] also argued that even though they are conservative in their lending practices, some loans may fall outside the criteria of the qualified mortgage label and would be difficult to sell on the secondary market.

The amended rule will extend qualified mortgage status to certain loans that creditors hold in their portfolios for a period of at least three years, even if the consumer's debt-to-income ratio exceeds 43 percent. With the exception of the debt-to-income threshold, loans must comply with all other qualified mortgage criteria. NCRC encourages the CFPB to use this class of qualified mortgage loans as an opportunity to assess the merit of the 43 percent debt-to-Income ratio.

III. The amendments raise the amount that small lenders can charge above the average prime offer rate.

This amendment seeks to address the argument from many small lenders and creditors that they often have a higher cost of funds and that the cost is recouped by allowing a greater flexibility in the amount of interest that could be charged for a loan. NCRC believes that allowing any lender to stray too far from the average prime offer rate could mean that consumers will needlessly pay a higher rate when they could actually qualify for more affordable credit. Small lenders and creditors must also be able to show that this increased cost of capital is a very real problem, and one that warrants an additional cost to consumers.

The amended rule expands the margin by which small creditor loans are allowed to exceed the average prime offer rate and still meet the criteria of qualified mortgage. In the original rule, small creditors were allowed to exceed the average prime offer rate by 1.5 percent. The amended rule allows them to exceed the average prime offer rate by as much as 3.5 percent. NCRC is wary of this expansion and encourages the CFPB to monitor the lending practices of small creditors closely to ensure that they do not abuse this expansion.

1. Small creditors are those creditors with no more than $2 billion in assets that originate no more than 500 first-lien mortgages each year that also comply with the ability-to-repay rules. They operate primarily in rural and underserved counties, as defined by the CFPB.

IV. The amendments delay the restrictions on balloon-payment loans for two years.

After the initial rule was released, small lenders in non-rural and underserved communities said that they would need time to transition away from riskier products, like balloon-payment mortgages, and that the CFPB should reexamine its definition of "rural" and "underserved" so that it does not eliminate so many lenders from those categories. NCRC believes that credit products like balloon-interest loans are high-risk products that place borrowers at the mercy of lenders when refinancing becomes an option. NCRC also believes that the CFPB's research is the best way to shape an appropriate and responsive definition of both "rural" and "underserved" for purposes of the qualified mortgage criteria.

The amendment addresses these concerns by delaying the restrictions on balloon mortgages for a period of two years. Small lenders offering balloon-payment mortgages will have a two-year transition period, regardless of whether they serve predominately rural or underserved communities. The CFPB also intends to take this two year period to study what should be the appropriate scope for "rural" and "underserved" and to work with lenders in those communities to create financial products that are both safe, and meet the needs of the community.

V. The amendments exempt specific government agencies, programs, and credit product from the ability-to-repay rule.

Finally, some concerns were raised about the scope of the exemptions from the ability-to-repay rule. The amendments make clear that the following are exempt from the rule:

A. Community Development Financial Institutions

B. Community Housing Development Organizations

C. Downpayment Assistance Provider of Secondary Financing

D. Nonprofit 501(c)(3) entities that provide credit to low and moderate-income households no more than 200 times per year

E. Credit instruments issued by programs administered by a Housing Finance Agency

F. Credit products issued through an Emergency Economic Stabilization Act program, including the Home Affordable Modification Program (HAMP).