Ability-to-Repay ("ATR") Analysis and
Qualified-Mortgage ("QM") Determination

DISCUSSION DRAFT

by

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This document represents consensus recommendations concerning the ability-to-repay ("**ATR**") and qualified-mortgage ("**QM**") requirements of Dodd-Frank. These recommendations are interrelated and dependent upon each other.

1.0 Qualified Mortgage

Congress intended QMs to comprise the vast bulk of the mortgage market, and they should. QM loans by statute have safer features associated with responsible lending and lower default rates than loans without those features, such as limited fees, full amortization, and limited terms. Congress gave loans with these features a litigation advantage precisely to incent lenders to make QM loans.

If the QM definition is construed narrowly, it will be more difficult for low-income and minority families to qualify for safer loans, and, to the extent that mortgage credit is available to them at all, many of these borrowers will be left to the part of the market where they will be significantly more vulnerable to equity stripping through high fees and bad practices. A large non-QM market would not by its size alone protect consumers, and the broad availability of loan features that experience has shown to entail greater risks for consumers and investors will add to costs without providing commensurate consumer benefits.

By contrast, a broad definition of QM would combine prudent lending with less litigation, benefiting homeowners, investors and lenders alike. It would also support access to credit, since secondary market standards are very likely to require loans to be QM.

2.0 Ability-to-Repay Determination

2.1 General standards

Statutory requirement

The statute states that "no creditor may make a residential mortgage loan unless the creditor makes a reasonable and good faith determination based on verified and documented information that, at the time the loan is consummated, the consumer has a reasonable ability to repay the loan, according to its terms, and all applicable taxes, insurance (including mortgage guarantee insurance), and assessments." TILA Section 129C(a)(1).

The ability-to-repay analysis should be based on factors that reflect capacity to repay as of the time of consummation, not willingness or propensity to repay.

- The determination of ability to repay is separate and distinct from the underwriting decision, which properly includes factors other than just ability to repay.

- The regulations and accompanying commentary should clarify that:

    - the statutory ATR analysis concerns the borrower's capacity (the statute uses the term "ability") to repay a loan through current income, assets (other than the home), and funds available, not the propensity to make such payments.

    - other factors unrelated to ATR that influence the credit decision (e.g., credit score, LTV, appraisal) should not be used by creditors in establishing the borrower's ATR or in challenging a creditor's determination of ATR.

    - while the statute refers to a consumer's "credit history," this reference was intended to ensure only that a lender obtained a consumer's credit report (which contains the consumer's credit history) to verify the consumer's debts and associated monthly obligations,[1] not that lenders should use the credit history or credit report to otherwise determine the borrower's ability to repay. Otherwise, it would make no sense that QM establishes a rebuttable presumption of ATR when QM does not discuss creditworthiness.

- The CFPB should adopt the portion of proposed commentary Paragraph 43(c)(1)-1, which clarifies that a creditor is required to "determine that a consumer will have a reasonable ability *at the time the loan is consummated* to repay the loan" (emphasis added). A change in a consumer's circumstances after consummation of the loan is not relevant to determining compliance with the rule, unless such events are documented in the consumer's application or by information provided by the consumer reasonably prior to consummation of the loan. For example, the creditor must consider the potential impact of a consumer's impending retirement and the consumer's ability to repay if the consumer's application contains a notation that the consumer plans to retire six months after the loan is made. However, a significant reduction in income due to a job loss that occurs after consummation or a significant obligation arising from a major medical expense arising after

[1] The proposal would require, as part of an ability-to-repay determination, a consumer's credit history. Proposed Regulation section 226.43(c)(2)(vi); Proposed Commentary Paragraph 43(c)(2)(viii). This improperly conflates the full underwriting analysis that all lenders must undertake in order to ensure safe and sound underwriting practices—which includes assessing creditworthiness, loan-to-value ratios, and other factors—with the statute's requirement to consider the borrower's capacity to repay. An analysis of a borrower's ability to repay a debt is simply one important part of a lender's full underwriting analysis.

the loan is consummated would not be relevant to an ability to repay challenge. *See* Paragraph 43(c)(1)-1.

The regulation and commentary should require creditors to verify and document income, assets, and debts using third-party sources.

- **Income or assets:** The final rule should adopt the proposed regulatory provisions and commentary that require verification of income or assets using third-party documentation that provides reasonably reliable evidence of the consumer's income or assets and that permit creditors to consider expected income if it is reasonable and documented. Proposed Rule section 226.43(c)(4); Proposed Commentary Paragraph 43(c)(2)(i)-1; Proposed Commentary Paragraph 43(c)(2)(i)-3. Dodd Frank requires that income and assets be appropriately documented and verified. However, this requirement can pose barriers to obtaining credit for some borrowers who have non-traditional or alternative income sources, such as boarder income and informal self-employment income, which is more difficult to document and verify. Since CFPB will have to confront and resolve these issues in issuing the final regulations, the parties would like to work with the CFPB to develop standards that specifically address how such non-traditional or alternative income sources can be considered by the creditor in the underwriting process and verified, including working through parties that work closely with borrowers, such as HUD-approved housing counselors.

- **Debts:** The CFPB should adopt Proposed Commentary Paragraph 43(c)(2)(vi)-1, which provides that creditors may look to widely accepted governmental and nongovernmental underwriting standards to define debts, and a creditor may, for instance, look to credit reports, as well as statements for student loans, auto loans, credit cards, etc., to determine a consumer's outstanding debts. However, see the discussion below regarding expenses not on a credit report or the consumer's application.

- **Reconciling different information:** The CFPB should adopt Proposed Commentary Paragraph 43(c)(2)(vi)-2, which provides that the creditor must consider debts in the credit report that are not listed on the consumer's application. The credit report is deemed a reasonably reliable third-party record under § 226.43(c)(3). "For debts not listed in the credit report, but offered by the borrower through the application process, the creditor need not verify the existence or amount of the obligation through another source. If a creditor nevertheless verifies an obligation, the creditor must consider the obligation based on the information from the verified source."

Ability to repay—when the creditor must consider expenses not listed on the credit report or the borrower's application

- The commentary should clarify that the lender must consider additional information that the borrower provides [in writing] a reasonable time before consummation about regular/recurring expenses that would have a material impact on the borrower's ability to repay the loan. However, the borrower would have the burden of proving that she had offered such information [in writing] reasonably prior to the consummation of the loan and that it would have a material impact on her ability to repay the loan. **[Note to CFPB: The parties disagree about whether this information must be provided in writing.]**

[There is agreement that the borrower needs access to information that describes how the lender conducted the ability-to-repay determination. The parties will attempt to propose a solution at a later date.]

2.2 Payment used to qualify the borrower—treatment of ARMs

For all ARMs, the ATR standard should require the following:

- The contract interest rate and payment *cannot*:
    - adjust more frequently than annually;
    - increase by more than 200 basis points in any annual rate adjustment; or
    - adjust by more than 500 basis points over the life of the loan.

- The borrower must be qualified based on the *maximum* rate and payment that could occur in the first 6 years of the term of the loan (that is, the rule would not allow the creditor to ignore the first rate and payment adjustment on a 5-1 ARM in the ATR analysis).

[**2.3** Potential ATR Carve-Out for Certain Streamlined Refinancings: There is agreement that an exception to the ability-to-repay and qualified-mortgage requirements should be established for certain streamlined refinancings. The parties will attempt to propose such an exception at a later date.]

3.0 QM Definition

All items below must be met in order for the loan to be a designated as a qualified mortgage:

3.1 Loan Terms

A qualified mortgage cannot have terms that provide for:

- an increase of the principal balance as a result of negative amortization based on regular required payments
- interest-only payments
- balloon payments
- a term greater than 30 years
- points and fees that exceed the greater of $3,000 or 3 percent of the total loan amount so long as the loan is not a HOEPA loan
- the contract interest rate and payment to:
    - adjust more frequently than annually;
    - increase by more than 200 basis points in any annual rate adjustment; or
    - adjust by more than 500 basis points over the life of the loan
- In addition, the borrower must be qualified based on the *maximum* rate and payment that could occur in the first 6 years of the term of the loan (that is, the rule would not allow a creditor to ignore the first rate and payment adjustment of a 5-1 ARM in the ATR analysis).

3.2 Documentation Requirements

The following documentation requirements would be required for QM loans:

- Verification of borrower income;
- Verification of employment ("**VOE**") status, if applicable (either written or oral VOE);
- Documentation of current debt obligations (based on credit report and borrower application); and
- Documentation of payments on simultaneous seconds and any other subordinated loans in place at origination.

3.3 Additional QM Underwriting Requirements

In order to be a qualified mortgage, a loan must meet at least one of the "waterfall" tests described below. However, the fact that a mortgage might qualify under one of these tests does not imply an obligation on the creditor's part to make the loan or to otherwise forego the underwriting process. All references to housing debt, housing obligations, and housing payments below would include principal, interest, taxes, insurance, condominium association fees and other housing-related obligations.

- If the borrower's total debt-to-income ratio ("TDTI") is 43 percent or less (with a bona fide error cushion), the loan would meet QM requirements. No other tests would be required.
- If the borrower's TDTI is more than 43 percent, the following tests could be applied:
  - *Front-End Ratio*: Is the borrower's housing debt-to-income ratio 31 percent or less of the borrower's gross monthly income and is TDTI 50 percent or less?
    - If yes, the loan meets QM requirements; no further test required. If no, continue.
  - *Previous Housing Payments*. Has the borrower had stable income for the past six months and made timely mortgage or rental payments over a specified period of time (TBD), and will her new monthly housing obligations be no more than 5 percent higher than her current housing expenses? [Parties are still discussing the appropriate definition and timeframe for establishing a history of "timely" payments.]
    - If yes, the loan meets QM requirements; no further test required. If no, continue.
  - *Reserves.* Does the borrower meet one of the following tests: 1) at least 6 months of liquid financial reserves available to meet mortgage-related obligations and a TDTI of 50% or less; or 2) greater than 18 months in liquid financial reserves (i.e., no TDTI cap required)? (Only 60 percent of any reserves with a withdrawal penalty would be allowed to count.) [Parties agree that some degree of seasoning should be required but do not have a specific recommendation.]
    - If yes, the loan meets QM requirements; no further test required. If no, continue.

– *Residual Income.* Is the borrower's net residual income above the minimum threshold established by the CFPB and/or other government agency (e.g., U.S. Department of Veterans Affairs ("**VA**")?

  - If yes, the loan meets QM requirements; no further test required. If no, the loan will only be made as a non-QM loan unless one of the prior tests in the waterfall is met.

  The residual-income test could be based on tax-adjustment tables and income guidelines prepared by CFPB, VA guidelines, or industry standards.

Even if the loan does not meet any of the QM tests, there is no implication that the loan fails to meet the ability-to-repay test.

4.0 Contesting the Presumption

We propose the following process:

- Borrower rebuts presumption when a borrower demonstrates that the loan fails to meet the basic tests of QM—product type, fee levels, etc.

- If the loan is a QM, the borrower can still assert that the ability-to-repay requirement was not met by demonstrating that the lender failed to take into account information provided to it that, if properly considered, would have prevented a reasonable and good faith finding of a reasonable ability to repay.

  - For example, the borrower shows that she provided information to the creditor before consummation that she owed debt that was not listed on the borrower's credit report. Failure to consider this debt could be grounds for challenging whether the ability-to-repay requirement was met. The lender could still have met the requirement if the existence of the debt did not materially affect a reasonable determination of the borrower's ability to repay.

  - Similarly, if a creditor alters or omits information collected in the course of the application, without reasonable basis, that is relevant to the borrower's ability to repay, the borrower can challenge whether the ability-to-repay standard was met.

  - Absent further information or evidence submitted by the borrower that either contradicts the creditor's records and assertions or documents information that the lender had but did not reasonably consider, the presumption for qualified mortgages should provide a sufficient shield to the lender.

- If the loan is not QM to begin with, the burden of proof that the lender did not appropriately consider the borrower's ability to repay falls on the lender. In this case, the lender will not have the benefit of the presumption of ability to repay when defending borrower claims that the lender failed to consider relevant information provided by the borrower.

- Accordingly, revise proposed Alternative 2 Commentary Paragraph 43(e)(1)-1 as follows [*additions in bold and deletions in strikethrough*]:

In general. Under § 226.43(c)(1), a creditor must make a reasonable and good faith determination at or before consummation that the consumer will have a reasonable ability, at the time of consummation, to repay the loan according to its terms, including any mortgage-related obligations. **A borrower raises a claim or defense of violation of sec 226.43(c)(1) by setting forth specific facts that, at the time the loan was consummated, the creditor did not make a reasonable and good faith determination that the borrower had a reasonable ability to repay the loan based upon information provided by the borrower reasonably prior to closing.** Under § 226.43(e)(1), a creditor or assignee of a covered transaction is presumed to have complied with the repayment ability requirement of § 226.43(c)(1) if the terms of the loan comply with § 226.43(e)(2)(i)-(ii) (or, if applicable, § 226.43(f)); the points and fees do not exceed the limit set forth in § 226.43(e)(2)(iii), and the creditor has complied with the underwriting criteria described in § 226.43(e)(2)(iv)–(v) (or, if applicable, § 226.43(f)). If a loan is not a qualified mortgage (for example because the loan provides for negative amortization), then the creditor or assignee must **prove** ~~demonstrate~~ that the loan complies with all of the requirements in § 226.43(c) (or, if applicable, § 226.43(d)). However, even if the loan is a qualified mortgage, the ~~consumer may rebut the presumption of compliance evidence that the loan did not comply with~~ **lender has not necessarily complied with the ability-to-repay requirement** in § 226.43(c)(1). For example, **(1)** evidence of a high debt-to- income ratio with no compensating factors, such as adequate residual income ~~could be sufficient to rebut the presumption~~, **or (2) evidence that the lender did not reasonably consider information provided to it relevant to the borrower's ability to repay could be used by the borrower to establish that the creditor did not meet the ability-to-repay requirement. When a loan is a qualified mortgage, the consumer has the burden of proving that the creditor did not comply with the repayment ability requirement of § 226.43(c)(1).**