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PROTECTING CONSUMERS FROM IRRESPONSIBLE MORTGAGE LENDING

When consumers apply for a mortgage, they often struggle to understand how much of a monthly payment they can afford to take on. They may assume that lenders and mortgage brokers will not make loans that people cannot afford. But in the years leading up to the financial crisis, lenders too often made mortgages that could not be paid back.

Today the Consumer Financial Protection Bureau (CFPB) is finalizing the Ability-to-Repay rule that requires lenders to obtain and verify information to determine whether a consumer can afford to repay the mortgage. This is one of the signature new rules the CFPB is issuing to meet its goal to help restore trust in the mortgage market.

BACKGROUND

- **In the lead up to the financial crisis, certain lending practices set consumers up to fail with mortgages they could not afford**. Lenders sold no-doc and low-doc loans where consumers were "qualifying" for loans beyond their means. Lenders also sold risky and complicated mortgages like interest-only loans, negative-amortization loans where the principal and eventually the monthly payment increases, hybrid adjustable-rate mortgages where the rate was set artificially low for years and then adjusted upwards, and option adjustable-rate mortgages where the consumer could "pick a payment" which might result in negative amortization and eventually higher monthly payments.

- **The deterioration in underwriting standards contributed to dramatic increases in mortgage delinquencies and rates of foreclosures.** What followed was the collapse of the housing market in 2008, and the subsequent financial crisis.

- **The Dodd-Frank Wall Street Reform and Consumer Protection Act recognized the need to mandate that lenders ensure consumers have the ability to pay back their mortgages.** Under the law, responsibility for drafting the Ability-to-Repay rule initially fell to the Board of Governors of the Federal Reserve System. Then, the CFPB took over responsibility in July 2011. The Act also provides the CFPB the authority to define criteria for certain loans called "Qualified Mortgages" that are presumed to meet the Ability-to-Repay rule requirements.

- **The CFPB conducted extensive research and analysis.** In May 2012, the CFPB sought public comment on new data and information. Through meetings with stakeholders on all sides, and rigorous analysis and research, the CFPB has come up with today's rule.

- **The Ability-to-Repay rule protects consumers from risky practices that helped cause the crisis.** It helps ensure that responsible consumers get responsible loans. And it helps ensure that lenders can extend credit responsibly – without worrying about competition from unscrupulous lenders.

<u>ABILITY TO REPAY</u>

Under the new Ability-to-Repay rule, lenders will have to determine the consumer's ability to pay back both the principal and the interest over the long term − not just during an introductory period when the rate may be lower. Lenders can no longer offer no-doc, low-doc loans, otherwise known as "Alt-A" loans, where some lenders made quick sales by not requiring documentation, then offloaded these risky mortgages by selling them to investors.

- **Financial information has to be supplied and verified:** Lenders must look at a consumer's financial records and verify them. At a minimum, a lender must consider eight underwriting standards:
  - Current income or assets;
  - Current employment status;
  - Credit history;
  - The monthly payment for the mortgage;
  - The monthly payments on any other loans associated with the property;
  - The monthly payment for other mortgage related obligations (such as property taxes);
  - Other debt obligations; and
  - The monthly debt-to-income ratio or residual income the borrower would be taking on with the mortgage. (Debt-to-income ratio is a consumer's total monthly debt divided by their total monthly gross income).

- **A borrower has to have sufficient assets or income to pay back the mortgage:** Lenders must make the determination the borrower can repay the loan by looking at the borrower's income and any assets they have on hand.

- **Teaser rates can no longer mask the true cost of a mortgage:** Lenders can't base their evaluation of a consumer's ability to repay the loan on teaser rates. Lenders will have to determine the consumer's ability to repay both the principal and the interest over the long term.

- **For consumers trying to refinance a risky loan, exemptions apply:** Creditors refinancing a borrower from a risky mortgage – such as an adjustable-rate mortgage, an interest-only loan, or a negative-amortization loan – to a more stable, standard loan can do so without undertaking the full underwriting process required by the new rules.

<u>QUALIFIED MORTGAGES</u>

Lenders will be presumed to have complied with the Ability-to-Repay rule if they issue Qualified Mortgages. Qualified Mortgages must meet certain requirements which prohibit or limit the risky features that harmed consumers in the recent mortgage crisis.

Features of Qualified Mortgages:

- **No excess upfront points and fees:** A Qualified Mortgage limits points and fees including those used to compensate loan originators, such as loan officers and brokers. When lenders tack on excessive points and fees to the origination costs, consumers end up paying a lot more than planned.

- **No toxic loan features:** Qualified Mortgages can't have the loan features that were associated with risky mortgages in the lead up to the crisis. Certain loans cannot be Qualified Mortgages:

- No interest-only loans, which are when a consumer only pays the interest for a specified amount of time so the principal does not decrease with payments;
- No loans where the principal amount increases, such as a negative-amortization loan; and
- No loans where the term is longer than 30 years.

- **Cap on how much income can go toward debt:** Qualified Mortgages generally will be provided to people who have debt-to-income ratios less than or equal to 43 percent. This cap on debt ensures consumers are only getting what they can likely afford. Before the crisis, many consumers took on mortgages that raised their debt levels so high that it was nearly impossible for them to repay the loan considering all their financial obligations. For a temporary, transitional period, loans that do not have a 43 percent debt-to-income ratio but meet government affordability or other standards − such as that they are eligible for purchase by the Federal National Mortgage Association (Fannie Mae) or the Federal Home Loan Mortgage Corporation (Freddie Mac) − will be considered Qualified Mortgages.

- **No loans with a balloon payment except those made by smaller creditors in rural or underserved areas:** The law generally prohibits loans with balloon payments from being Qualified Mortgages. Balloon-payment loans require a larger-than-usual payment at the end of the loan term. A small creditor operating in rural or underserved areas is permitted to originate such loans as Qualified Mortgages under certain defined circumstances.

Types of Qualified Mortgages:

- **Qualified Mortgages with rebuttable presumption:** These are higher-priced loans typically for consumers with insufficient or weak credit history. If the loan goes south, the consumer can rebut the presumption that the creditor properly took into account their ability to repay the loan. They would have to prove the creditor did not consider their living expenses after their mortgage and other debts. This does not affect the rights of a consumer to challenge a lender for violating any other federal consumer protection laws.

- **Qualified Mortgages with safe harbor:** These are lower-priced loans that are typically made to borrowers who pose fewer risks. If the loan goes south, the lender will be considered to have legally satisfied the ability-to-repay requirements. But consumers can still legally challenge their lender under this rule if they believe that the loan does not meet the definition of a Qualified Mortgage. This does not affect the rights of a consumer to challenge a lender for violating any other federal consumer protection laws.

<u>PROPOSED ABILITY-TO-REPAY AMENDMENTS</u>

Today, the CFPB is also inviting comment on proposed amendments to its Ability-to-Repay rule that include:

- Exemptions for nonprofit creditors that work to help low- to moderate-income consumers obtain affordable housing;
- Exemptions for housing finance agencies and lenders participating in housing finance agency programs intended to foster community development;
- Exemptions for homeownership stabilization programs that work to prevent foreclosures, such as programs operating in conjunction with the Making Home Affordable program;

- A provision to give Qualified Mortgage status to small creditors, such as community banks and credit unions that make and hold loans in their own portfolios.

As part of this proposal, the CFPB is also seeking comment on how best to calculate the loan origination compensation that will be part of the limitation on points and fees for Qualified Mortgages.