CENTER FOR RESPONSIBLE LENDING

CFPB Regulations Establish a Broad Qualified Mortgage Definition

January 3, 2014 CRL Fact Sheet

Overview

In order to address the risky lending practices that led to the foreclosure crisis, the Dodd-Frank Wall Street Reform and Consumer Protection Act established the Ability to Repay and Qualified Mortgage reforms. As a result, all lenders have a responsibility to perform basic underwriting by making a reasonable determination whether a borrower can afford a loan. Lenders can choose to meet this responsibility by originating Qualified Mortgages, which are restricted from having risky product features.

The Consumer Financial Protection Bureau (CFPB) promulgated regulations that established four pathways to Qualified Mortgage status. This results in a definition that provides consumer protections while also ensuring broad access to credit. The CFPB's Qualified Mortgage provisions go into effect for lenders on January 10, 2014.

Universal Product Feature Requirements

All four of the CFPB's Qualified Mortgage pathways require meeting basic product feature requirements:

- **Must be fully amortizing** (i.e., no interest-only or negatively amortizing loans)
- **Points and fees cannot exceed 3%** of the total loan amount (with adjusted thresholds for smaller loans)
- **Loan terms cannot exceed 30 years**
- **Adjustable-rate loans must be underwritten to the maximum rate** permitted during the first five years

4 Pathways to Qualified Mortgage Status

Mark Zandi of Moody's Analytics estimates that the four Qualified Mortgage pathways cover more than 95 percent of the current market. Each are outlined below.

1. **General Definition:**

The general definition requires that borrowers have a back-end debt-to-income ratio of 43% or below. Lenders must collect and verify a borrower's income, assets, debts and other obligations according to standards established in the regulation, which are found in Appendix Q of the regulation, in order to calculate the borrower's debt-to-income ratio. Additionally, loans under this category cannot be balloon loans.

2. **Compensating Factors Definition:**

The CFPB created a temporary definition that allows loans eligible for insurance or guarantee by Fannie Mae, Freddie Mac, the Rural Housing Service, and the Veterans Administration to gain Qualified Mortgage status. These agency guidelines use underwriting standards called "compensating factors" to approve some borrowers with a debt-to-income ratio above 43%.

This temporary definition (available for a maximum of seven years) does not require that the GSEs or government agencies actually insure or guarantee loans under this category – only that loans would be eligible under the specified underwriting requirements for one of the agencies.

In addition, the Federal Housing Administration (FHA) has issued its own Qualified Mortgage definition, which outlines that loans insured by FHA have Qualified Mortgage status. FHA loans also incorporate compensating factors into their approved underwriting standards.

3. **Portfolio Loans Originated by Small Creditors Definition:**

This definition is not required in the Dodd-Frank Act, but the CFPB created it using its regulatory authority with the goal of preserving access to credit. Under this definition, lenders need to meet two criteria to count as a small creditor: first, have assets of no more than $2 billion and second, originate no more than 500 first-lien mortgages per year. Additionally, loans must be held in portfolio for at least three years. The lender is "required to consider the consumer's debt-to-income ratio or residual income and to verify the underlying information." However, borrowers do not need to meet the 43% debt-to-income ratio threshold or use the debt-to-income ratio standards in Appendix Q.

4. **Balloon-Loan Definition:**

The CFPB also created a Qualified Mortgage definition specific to balloon loans. The CFPB used its regulatory authority to establish a two-year transition period that allows all small creditors – regardless of whether they operate in rural or underserved areas – to obtain QM status for balloon loans that are held in portfolio. After the transition period, the balloon loan definition only applies to those lenders who operate in rural or underserved areas under a definition that the CFPB will continue to study. As in the small creditor definition, the lender must evaluate the borrowers debt-to-income ratio (or residual income), but is not required to adhere to the 43% ratio used in the general definition.

Safe Harbor vs. Rebuttable Presumption

When a loan gains status as a Qualified Mortgage, it carries with it a legal presumption of complying with the Ability to Repay requirements. The CFPB's final rule creates two different kinds of legal presumption: a safe harbor and a rebuttable presumption. Under a safe harbor, a borrower is unable to challenge whether the lender met its ability to repay obligations. Under a rebuttable presumption, the borrower has the ability to raise a legal challenge but must overcome the legal presumption that the lender complied with this obligation.

Determining which legal category a loan falls into requires comparing the APR with a benchmark called the average prime offer rate (APOR). For loans meeting the CFPB's general and compensating factors definitions, first lien loans receive a safe harbor if the APR is no greater than 1.5% above the APOR benchmark. Loans exceeding 1.5% above APOR receive a rebuttable presumption. For loans meeting the CFPB's small creditor and balloon loan definitions, a safe harbor applies if the APR on a first lien is no greater than 3.5% above APOR.

Under FHA's Qualified Mortgage rule, loans receive a safe harbor if the APR does not exceed 115 basis points plus the on-going FHA mortgage insurance premium for that loan. Loans above this threshold receive a rebuttable presumption.