Ability to Repay and Qualified Mortgages

Compliance Training

Bankers ADVISORY
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Dodd Frank

ATR Rule and Qualified Mortgages

- TILA requirement added by Dodd-Frank prohibits creditors from making a residential mortgage loan without first verifying the consumer's ability to repay the loan
- Implementation: Regulation Z, Section 43, effective January 10, 2014
- Violations of the Ability to Repay rule carry substantial penalties
- Making a "Qualified Mortgage" (QM) gives creditor legal protections from claims

ATR Key Provisions

Regulation Z, Section 43

- Creditor must make a reasonable and good faith determination that the consumer will have a reasonable ability to repay the loan according to its terms
- Determination of the consumer's ATR must be based on the consideration of eight underwriting factors related to repayment ability
- Information relied on by creditor for ATR determination must be verified using reasonably reliable third-party records
- Compliance alternatives provided
- Prepayment penalty restrictions

ATR Coverage

Applicability

- Consumer credit transactions secured by a dwelling
- Includes second homes, not just primary residences
- Prepayment penalty provisions from rule apply to some transactions not subject to the repayment ability provisions

Exceptions

- HELOCs
- Timeshares
- Reverse mortgages

ATR Coverage

Exceptions continued:

- Temporary financing, construction-only phase (≤ 12 months) for construction-permanent financing
- Extension of credit under program administered by a Housing Finance Agency (defined in 24 CFR 266.5)
- Extensions of credit under Emergency Economic Stabilization Act program 12 USC 5211; 5219
- Extension of credit made by:
  - Community Development Financial Institution
  - Down payment Assistance through Secondary Financing Provider
  - Community Housing Development Organization
  - Certain 501(c)(3) tax exempt creditors

ATR Determination

Reasonable and Good Faith

Consider, at a minimum the following **eight factors**:

1. Current or reasonably expected income or assets
2. Current employment status
3. Monthly payment for principal and interest
4. Monthly payment for any simultaneous loan
5. Monthly payment for mortgage-related obligations
6. Consumer’s current debt obligations, alimony, and child support
7. Monthly debt-to-income ratio or residual income
8. Credit history

ATR Determination

Reasonably reliable third-party records

- IRS tax transcripts or copies of tax returns filed by consumer
- IRS Form W-2 or similar forms
- Payroll statements or financial institutions records

Monthly payment calculation requirements

- Use the greater of fully indexed rate or any introductory interest rate
- Use monthly, fully amortizing payments that are substantially equal

ATR Determination

Simultaneous Loan

- Another closed-end consumer loan or HELOC secured by same dwelling and made to the same consumer

Mortgage-related Obligations

- Property taxes; premiums and similar charges for insurance required by creditor; fees and special assessments imposed by a condo, coop, or homeowners' association; ground rent; and leasehold payments

- Mortgage-related obligations attributable to the simultaneous loan must also be considered

ATR and QM

Compliance with ATR rule may be achieved by originating a QM loan

Two levels of legal protection:

- Safe Harbor for QM loan that is not higher-priced
- Rebuttable Presumption of Compliance for QM that is higher-priced

Higher-priced QM:

- QM APR exceeds the APOR for a comparable transaction as of the date the interest rate is set 1.5 percentage points for first lien
  - 3.5 percentage point for subordinate liens

QM Protections

Safe Harbor

- Stop litigation in earliest stage by establishing loan's status as QM

Rebuttable Presumption

- Even after QM status is established, consumer has opportunity to rebut presumption
- IF consumer successfully rebuts the presumption of compliance, the question reverts to whether or not Creditor complied with the general ATR rule: "good faith determination based on information verified using reasonably reliable third-party records"
  - Consumer success in rebutting the presumption of compliance indicates the outcome of the underlying ATR question

QM Criteria

QMs are transactions satisfying the following six criteria:

1. Regular periodic payments that are substantially equal
2. Loan term ≤ 30 years
3. Total points and fees payable in connection with loan do not exceed established limits *(3% of total loan amount for loans ≥ $100,000)*
4. Monthly payment used for underwriting must be based on maximum interest rate applicable during first 5 years and fully amortizing periodic payments, and monthly payment for mortgage-related obligations must be considered
5. Current or reasonably expected income or assets, other than the value of the security, and the consumer's current debt obligations, alimony, and child support verified in accordance with Appendix Q
6. Ratio of consumer's total monthly debt to total monthly income is ≤ 43%

QM Criteria

Requirement #1 Regular, substantially equal, periodic payments

- Exception for effect of interest rate change after consummation on payment in the case of an adjustable or step-rate mortgage, **as long as** the adjustable or step-rate mortgage does not:
  - Result in an increase of the principal balance
  - allow the consumer to defer payment of principal, or
  - result in a balloon payment, except if permitted under rules governing balloon payment QMs made by certain creditors (1026.43(f))

Requirement #2 Loan term may not exceed 30 years

- 30 years calculated from date of first payment, not consummation

QM Criteria

Requirement #3 Limited Points & Fees

- Total points and fees payable in connection with the loan may not exceed:
  - 3% of the total loan amount *(loan amounts ≥ $100,000)*
  - $3,000 indexed for inflation *(loan amounts ≥ $60,000, but < $100,000)*
  - 5% of the total loan amount *(loan amounts ≥ $20,000 but < $60,000)*
  - $1,000 indexed for inflation *(loan amounts > $12,500 but < $20,000)*
  - 8% of the total loan amount *(loan amounts < $12,500)*

Determining Points & Fees

“Points & Fees” means the following fees or charges that are *known at or before consummation*:

<u>Six general categories listed in 1026.32(b)(1)</u>

i. Finance charges
ii. Loan originator compensation
iii. Real estate related fees
iv. Insurance premiums
v. Maximum prepayment penalty
vi. Prepayment penalty in refinance by current holder

Several cross references, exceptions, conditions, and criteria apply to the above categories of fees and charges

Determining Points & Fees

Category 1 – Finance Charges

- Regulation Z, Section 1026.4 finance charges are included in total *except for the following:*
  - Interest, or time-price differential
  - Federal or state government-sponsored mortgage insurance premium
  - Private mortgage insurance (PMI) premiums payable after consummation
  - PMI upfront premium up to amount of FHA up-front MIP at origination, if refundable on prorated basis automatically upon satisfaction
  - Bona fide third-party charges not retained by institution, loan originator, or an affiliate **unless** fee is:
    - » Included under the rule for upfront PMI (excess amount)
    - » Included as Real Estate Fees under separate provision
    - » Included as insurance premium under separate provision

Determining Points & Fees

Category 1 – Finance Charges

- Finance charges under Regulation Z, Section 1026.4, are included in the total *except for the following*
  - Bona fide discount points as follows so long as the interest rate without any discount does not exceed the applicable Average Prime Offer Rate (APOR) by more than two percentage points
    - » Exclude up to two points, if the interest rate without any discount does not exceed the applicable APOR by more than 1%; or
    - » Exclude up to one discount point if the interest rate exceeds the APOR by more than 1 % but less than 2%

"Bona fide discount point": Amount equal to 1% of the loan amount paid by consumer to reduce interest rate based on a calculation consistent with established industry practices for determining amount of reduction appropriate for discount point paid by the consumer

Determining Points & Fees

<u>Category 2 – Loan Originator Compensation</u>

- Include loan originator compensation to extent known as of date interest rate is set
  - *Exception:* compensation paid by creditor, mortgage broker, or manufactured home retailer to an **<u>employee loan originator</u>** is not counted
- Include compensation paid directly by consumer to mortgage broker ***unless*** payment is already included in total points & fees because it is a finance charge
- Include compensation paid by creditor to mortgage broker

Determining Points & Fees

Category 3 – Real Estate Related Fees

- Real estate-related fees are excluded from the finance charge, but may need to be included in calculation of total points & fees if:
  - Fee is unreasonable
  - Institution receives direct or indirect compensation in connection with the charge
  - Fee is paid to an affiliate of the creditor

Affiliate means: any company that controls, is controlled by, or is under common control with another company, as set forth in the Bank Holding Company Act of 1956

Determining Points & Fees

Category 4 – Insurance Premiums

- Include premiums or other charges payable at or before consummation for any credit life, credit disability, credit employment, or credit property insurance, or any other life, accident, health, or loss-of-income insurance for which the creditor is a beneficiary

- Include any payments directly or indirectly for any debt cancellation or suspension agreement or contract

Determining Points & Fees

Category 5 – Maximum Prepayment Penalty

- Include the maximum prepayment penalty that may be charged or collected under the terms of the mortgage loan.

Category 6 – Prepayment Penalty in certain Refinances

- Include prepayment penalty incurred by consumer refinancing with current holder of the existing loan or plan, a service acting on behalf of current holder, or an affiliate of either

Determining Points & Fees

Charges paid by parties other than the consumer

- Points & fees may include charges paid by third parties in addition to charges paid by the consumer
  - Charges otherwise included as points and fees based on the rules covering finance charges, compensation, real-estate related fees, and premiums, paid by third parties must be counted towards the points & fees limit
- Examples
  - Third-party payment of a creditor-imposed fee for an appraisal performed by an employee of the creditor is included

Determining Points & Fees Threshold

"Loan Amount" determines threshold *(not the "Total Loan Amount")*

Total points and fees payable in connection with the loan may not exceed:

- 3% of the total loan amount *(loan amounts ≥ $100,000)*
- $3,000 indexed for inflation *(loan amounts ≥ $60,000, but < $100,000)*
- 5% of the total loan amount *(loan amounts ≥ $20,000 but < $60,000)*
- $1,000 indexed for inflation *(loan amounts > $12,500 but < $20,000)*
- 8% of the total loan amount *(loan amounts < $12,500)*

For percentage-based thresholds, determine "total loan amount" for to calculate limit

Determining “Total Loan Amount”

Total Loan Amount = “Amount Financed” – *certain creditor-financed “points & fees”*

- Total Loan Amount is calculated the same way for both QM and HOEPA coverage threshold
- Amount Financed under 1026.18(b)
- *IF* a charge is counted toward *“total points & fees”* under the following three categories of fees, and is creditor-financed, that amount must be subtracted from the Amount Financed in order to determine the “Total Loan Amount”
  - Real-estate related fees
  - Premiums for any credit life, disability, unemployment…
  - Total prepayment penalty if refinance of loan held by creditor or affiliate

QM Criteria

Requirement #4 Maximum Interest Rate and Mortgage-related Obligations

Underwriting must utilize the following:

- Monthly payment for principal and interest calculated using the ***maximum interest rate*** that may apply during the first five years after the date on which the first regular periodic payment will be due
- Periodic payments of principal and interest that will repay either the loan amount over the loan term, or the outstanding principal balance over the remaining term
- Monthly payment for any mortgage-related obligations

QM Criteria

Requirement #4 Maximum Interest Rate *continued*

- Fixed-rate mortgages use interest rate in effect at consummation

- Adjustable rate mortgages
  - Assume interest rate increases after consummation as rapidly as possible, taking into account the terms of the legal obligation, and apply adjustment caps as applicable

QM Criteria

Requirement #5 Verification of consumers income, assets, and debt obligations

Consumer's current or reasonably expected income or assets, other than the value of the security, and the consumer's current debt obligations, alimony, and child support must be verified using **Appendix Q** guidelines

Requirement #6 Total monthly debt to total monthly income ratio must be ≤ 43%

Ratio of total monthly debt to total monthly income is ≤ 43% calculated in accordance with the standards in **Appendix Q,** and using the consumer's monthly payment on the covered transaction, including mortgage-related obligations and any simultaneous loan

Appendix Q

Effective Income

Income must be stable, verifiable, and continuing to be “effective”

- Verification of employment history
  - Most recent two full years with any gaps of 1 or more months explained
- Analysis of consumer’s employment record
  - Examine past employment record and confirm current, ongoing employment status
- Creditors may *assume* employment is “ongoing” if current employment verification does not indicate employment is set to be terminated
  - Extended absences explained

Appendix Q

Forms of Income

Analyze income for each consumer obligated for mortgage debt to determine whether income level can be reasonably expected to continue through at least the first three years of the mortgage loan

Overtime and Bonus Income

- Overtime and/or Bonus income may be used to qualify received for past two years and likely to continue
  - Develop average of bonus or overtime income for past 2years
  - If < 2 years document reason for use in writing
  - Establish earning trend and if continual decline, document in writing a sound rationalization for use; if significant variation between two years, period must be extended for average

Appendix Q

Self-employment Income

- Consumer with an ownership interest in a business ≥ 25%
- Self-employment history of two years or more
- For history less than two years, income may only be considered stable and effective as follows:
  - At least two years of previous successful employment in same line of work as self-employment, or in related occupation
  - Combination one year of self-employment and formal education or training in same line of work or related occupation
- Income from self-employment for less than one year is not effective

Appendix Q

Documentation requirements for self-employed consumers

- Individual tax returns, with all applicable tax schedules for the most recent two years *(signed and dated)*
- Federal business income tax returns for the last two years, with all applicable tax schedules for a corporation, S-Corp, or partnership *(signed)*
- Year to date profit and loss (P&L) statement and balance sheet

Establishment of earnings trend for self-employed consumers

- Use quarterly tax filings for previous two years or P&L
- If current year P&L considerably greater than previous two year's tax returns, creditor must base income solely on the income verified through the tax returns

Financial strength of self-employed consumer's business

- Annual earnings which are stable or increasing are acceptable, while business that show a significant decline over the analysis period are not acceptable

Appendix Q

Non-Employment Related Consumer Income

*Alimony, Child Support, and Maintenance **<u>Income</u>*** ***(remember ECOA!)***

- Income is "effective" if the following criteria are satisfied:
  - Income is likely to be received consistently for the first 3 years of the mortgage
  - Income is documented by either copy of final divorce decree; legal separation agreement; or court order; or voluntary payment agreement
  - Receipt of payments during the past 12 months verified and documented by acceptable evidence (*< 12 months may be acceptable if adequately document the payer's ability and willingness to make payments)* : "acceptable evidence" includes: cancelled checks, deposit slips, tax returns, court records
- Child Support may be "grossed-up" under same provisions as non-taxable income

Appendix Q

Non-Employment Related Consumer Income

Rental Income

- Stability of Rental Income
  - Current lease
  - Agreement to lease
  - 24-month rental history free of unexplained gaps > than 3 months

Rental Income from Property Being Vacated by Consumer

- Rental income from a principal residence that is being vacated in favor of another principal residence may not be considered, except for
  - Relocations
  - Sufficient Equity in Vacated Property LTV of 75% or less

Appendix Q

Consumer Liabilities: Recurring Obligations

- Installment loans
- Revolving charge accounts
- Real-estate loans
- Alimony
- Child Support
- Other continuing obligations

Appendix Q

Computing Debt to Income Ratio for Recurring Obligations

Include:

- Monthly housing expense
- Recurring charges extending ten months or more:
  - Installment account payments
  - Revolving accounts (even if it appears balance will be paid off within ten months)
  - Child support or separate maintenance payments
  - Alimony
- Debts less than ten months must be included if the amount of the debt affects the consumer's ability to pay the mortgage during the months immediately after closing

QM Special Rules

Eligible Loan QM

- Loans eligible to be purchased or guaranteed by Fannie/Freddie while under conservatorship or receivership of FHFA, or loans eligible to be insured by HUD; guaranteed by VA; guaranteed by USDA; or insured by RHS
  - Sunsets at the earlier of: effective date of a rule issued by each agency or January 10, 2021

Repurchase and indemnification demands not necessarily dispositive of QM status

- Whether a particular loan satisfied QM eligibility criteria at consummation may be uncovered in course of dealing over a particular demand
  - Assume QC determines reported income of $50,000 was not documented and DU would not render Approve/eligible if accurate income figure of $35,000 was used
  - Loan was never a QM

QM Special Rules

Small Creditor Options:

- Balloon-payment QMs
- Small Creditor Portfolio

Current Small Creditor designation:

- Less than $2,028,000,000 total assets as of December 31, 2013

QM Special Rules

Balloon-payment QM

Option for small creditor operating in rural or underserved area

- Temporary option (until January 10, 2016) for small creditors which are NOT in rural/underserved areas

Requirements for Balloon-payment QMs

- Transaction must not have negative amortization or total points and fees that exceed the limits applicable to QMs and must meet the following criteria:
- Fixed interest rate and periodic payments (other than the balloon payment) that would fully amortize the loan over 30 years or less
- Term of five years or longer
- Loan must not be subject to a forward commitment

QM Special Rules

Small-creditor QM

Criteria

- Underwrite using fully-amortizing schedule and maximum rate-permitted during the first five years after the date of the first payment
- Loan may not be subject to a forward commitment
- Income or assets, and debts, alimony, and child support must be considered and verified
- DTI or residual income must be considered, but no specific threshold established

Prohibited Features

- Negative-amortization
- Interest-only or balloon-payment features
- Term exceeding 30 years
- Points and fees exceeding corresponding QM limit

QM Special Rules

Small-creditor QM *continued*

- QM status is lost if loan is sold or transferred within three years of consummation
- Limited exception applies if loan is sold under one of the following conditions:
  - Sold more than three years after consummation
  - Sold to another creditor that meets the criteria regarding number of originations and asset size, any time
  - Sold pursuant to a supervisory action or agreement, any time
  - Transferred as part of a merger or acquisition of or by the creditor, any time

QM Points & Fees Analysis

A. FINANCE CHARGES	
INCLUDE	EXCLUDE
Finance charges determined in accordance with Regulation Z, 1026.4 are included in the calculation of the QM loan's "points and fees"	Interest or time-price differential Federal/state Mortgage Insurance Premium (MIP) or Guarantee fee
Portion of Private Mortgage Insurance (PMI) Upfront premium exceeding amount of current FHA upfront MIP	only as follows: Amount of Private Mortgage Insurance upfront premium up to the amount of current FHA upfront MIP Monthly or annual premium payable after consummation
Third-party charges retained by institution or affiliate	Bona-fide third party charges not retained by institution or affiliate
Real-estate related fees even if excluded from the finance charge, if paid to an affiliate of the institution	Real-estate related fees only if all of the following criteria are satisfied: Charge is reasonable; and Institution receives no direct/ indirect compensation connected to charge; and Charge is not paid to an affiliate

QM Points & Fees Analysis

B. DISCOUNT POINTS	
INCLUDE	**EXCLUDE**
Discount points as follows based on the extent to which the loan's interest rate exceeds the applicable APOR: **All discount points included if rate exceeds APOR by more than 2 percentage points**	Bona-fide discount points only as follows: Up to two points, included if rate does not exceed APOR by more than 1 percentage point; One point only, if rate exceeds APOR by no more than 2 percentage points, but more than 1 percentage point
C. LOAN ORIGINATOR COMPENSATION	
INCLUDE	**EXCLUDE**
Loan Originator Compensation paid directly or indirectly by a consumer or creditor to a loan originator **Also include:** **Compensation paid by a consumer or creditor to mortgage broker a manufactured home retailer, and compensation included in the sales price of a manufactured home, if known**	Loan Originator Compensation if paid BY a broker, creditor, or retailer TO an employee Also exclude: Compensation paid directly by consumer to a mortgage broker only if the amount has already been included in the calculation as a finance charge
D. PREPAYMENT PENALTIES	
INCLUDE: Amount of maximum prepayment penalty that a consumer may be charged in connection with the transaction. If the transaction is a refinance of a loan currently held by the institution or an affiliate, include amount of any prepayment penalty paid in connection with the loan being paid.	

Thank You

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