Our Perspectives:
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Barnett Sivon & Natter P.C.
ATTORNEYS at LAW
WASHINGTON, DC

The Debt-to-Income Standard in the QM Regulation[*]

Raymond Natter

September, 2013

Beginning on January 10, 2014, mortgage lenders will be exposed to considerable liability if they originate a mortgage without first making a reasonable and good faith determination, based on verified and documented information, that the consumer has a reasonable ability to repay the loan according to its terms, along with applicable taxes, insurance and assessments. This would appear to be a common sense approach to making loans, and a policy that all residential mortgage lenders should follow. However, because the nature of the determination is subjective, it also opens up the possibility that a lender will face liability for making an inadequate "ability to repay" determination after the loan is made. Congress was well aware of this potential, and therefore directed the CFPB to issue a regulation defining the parameters of a "qualified mortgage" that would provide a safe harbor to protect responsible lenders from this potential liability.

The CFPB published a final regulation defining the terms of a qualified mortgage earlier this year. Under these regulations, most mortgages meeting certain prescribed requirements will be considered to be "qualified mortgages," and the lender could not be challenged on the basis of failing to comply with the "ability to repay" requirement. For mortgages that are deemed to be "higher cost" loans, the safe harbor would be changed to a presumption of compliance that could be rebutted by the consumer.

Although the concept of a "qualified mortgage" would appear to be simple to execute, the regulatory requirements are complex and, to a certain extent, ambiguous. This problem can be illustrated by two independent requirements in the regulation regarding acceptable debt-to-income ratios. Loan underwriters typically consider two ratios. "Front-end" ratios consider the consumers monthly mortgage-related debt (including taxes and property

[*] The information contained in this newsletter does not constitute legal advice. This newsletter is intended for educational and informational purposes only.

insurance) to monthly income. "Back-end" ratios consider the consumer's total monthly debt to monthly income.

The QM regulation likewise has two separate requirements relating to the debt-to-income standard. One regulatory requirement establishes a 43 percent debt-to-income limitation for qualified mortgages. The relevant regulatory language states:

> (e) Qualified mortgages...
>
> (2) Qualified mortgage defined-general...
>
> (vi) ... (T)he ratio of the consumer's total monthly debt to total monthly income at the time of consummation does not exceed 43 percent. For purposes of this paragraph (e)(2)(vi), the ratio of the consumer's total monthly debt to total monthly income is determined:
>
> (A) Except as provided in paragraph (e)(2)(vi)(B) of this section, in accordance with the standards in appendix Q;
>
> (B) Using the consumer's monthly payment on:
>
> (*1*) The covered transaction, including the monthly payment for mortgage-related obligations, in accordance with paragraph (e)(2)(iv) of this section; and
>
> (*2*) Any simultaneous loan that the creditor knows or has reason to know will be made, in accordance with paragraphs (c)(2)(iv) and (c)(6) of this section.[1]

This regulatory language seems to state that the 43 percent debt-to-income test is a "front-end" ratio, i.e., that it is a mortgage-related debt-to-income standard. A second regulatory provision appears to require consideration of a back-end ratio. This states that a lender must consider:

> (A) The consumer's current or reasonably expected income or assets other than the value of the dwelling (including any real property attached to the dwelling) that secures the loan...; and
>
> (B) The consumer's current debt obligations, alimony, and child support ...[2]

[1] 12 C.F.R. §1026.43(e)(2)(vi).
[2] 12 C.F.R. §1026.43(e)(2)(v).

This test, unlike the first standard described, appears to be focused on the total debt obligations of the borrower, including obligations such as alimony and child support. However, unlike the first standard, there is no quantitative measure as to what is an acceptable ratio of total debt-to-income.

It could be argued that this second standard merely requires a lender to "consider" the consumer's total debt-to-income, and as long as the lender notes in the loan file the existence and amount of such debt, the regulatory compliance has been met. This, however, would not be consistent with the goal of having a meaningful measure of a qualified mortgage. Furthermore, the case law is quite strong in holding that when a statute or regulation requires the "consideration" of a factor, it requires more than simply noting the existence of certain facts. The courts have typically held that a factor is not adequately considered unless the decision-maker explains how the factor was taken into account and why it is consistent with the ultimate decision.[3]

The material issued by the CFPB in connection with the QM regulation indicates that there was an intent to have two different debt-to-income standards, but these documents leave questions unanswered. The official commentary on the 43 percent limit states that "as provided in appendix Q ... creditors must include in the definition of "debt" a consumer's monthly housing expense."[4] No other types of debt are specifically mentioned. The commentary on the debt-to-income standard that does not include a quantitative limit notes that it may include types of debt that are not included in the 43 percent test.[5] Appendix Q to the regulation provides that the 43 percent test is based on *total* monthly debt.[6] However, a chart prepared by the CFPB indicates that alimony and child support is not part of the 43 percent standard. Thus, the exact scope of each of the debt-to-income standards is not clearly established in these materials.

In light of these facts, it is possible that a court would find that the regulation establishes two debt-to-income standards. One standard is satisfied if the debt is no more than 43 percent of income. A second standard, comparing a different amount of debt-to-income, is also mandated, and a lender may be required to demonstrate that it "adequately" considered that ratio when making the loan. This could lead to the courts, in effect, determining

[3]See, e.g., *Burlington Truck Lines v. United States, 371 U.S. 156, (1962).*
[4]Comment 43(e)(2)(vi).
[5]Comment 43(e)(2)(v).
[6]12 C.F.R. part 1026, Appendix Q.

what is and what is not an acceptable ratio under the second standard, and that ratio may not be 43 percent.

As shown by the above discussion, there are many complexities in the qualified mortgage regulation. Exactly how the CFPB and the courts will interpret and apply the regulation is not entirely clear. Hopefully, the CFPB will provide a specific explanation of how these two debt-to-income standards differ, and provide further guidance on what a permissible ratio will be for purposes of meeting the QM definition before the January 10, 2014 effective date.

Raymond Natter is a partner with the law firm of Barnett Sivon & Natter, P.C.