Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

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Two Brief Comments on the New Ability-to-Pay (ATR) Rule[*]

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First, the insistence on a solid 43 percent debt-to-income (DTI) ratio will exclude many very solid applications from qualification as a Qualified Mortgage and hence protected by the safe harbor found in the rule for Qualified Mortgages. If unprotected, many, if not most, of them will not be made. This will be true even if the applicant had a very high credit score (say 750) and a very significant down payment (say sufficient to create a loan-to-value (LTV) of 60 percent). Yet, most industry observers believe that LTV and credit scores are better predictors of borrower default than DTI.

Default from borrowers that have a beginning LTV of 60 percent and a credit score of 750 would be very low, and the predictions of default would be highly reliable. Yet, those predictors are trumped by relying upon a relatively weak predictor, DTI, and setting a firm cap on that predictor.

The Housing Policy Council submitted a letter to the Bureau in July of 2012 in which it analyzed some of the data the Bureau had produced and for which the Bureau sought analysis and comment. In reviewing the data (data that unfortunately was not divided into separate categories of DTIs over 46 percent), the HPC focused on the need for the Bureau to reflect the dynamic nature of the rule. For example, using actual 2009 data from the Bureau, HPC demonstrated that the volume of loans made when DTIs were limited to 40 to 42 percent dropped over $10,000,000,000 or over 18 percent when compared with the volume that would have been made if DTIs of 44 to 46 percent were permitted. Yet, the default rate only decreased from 1.59 percent to 1.43 percent. In other words, over $10 billion in loans were denied in exchange for decreasing the default rate by a mere 0.16 percent when the lower DTI ratio was used.

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

It makes sense to view the data dynamically, and had the Bureau done so, it would have found solid justification in using substantially higher DTI limitations. Considerably more "good" loans would have been able to be made under the protection of a safe harbor with only a very modest increase in defaults.

The Bureau should consider (1) the dynamic use of DTI and (2) whether to rely significantly on a feature such as DTI which is only minimally predictive of default. Further consideration should result in changes in this part of the formula for determining what loans are Qualified Mortgages.

Second, the Bureau refused to include directly in its regulations a provision that it gives great deference to in the Official Staff Interpretations. If a borrower makes consistent full payments for a number of payment periods after origination of the loan, it is solid evidence that the lender had a reasonable belief that the borrower had the ability to repay the loan at origination. If that period is sufficiently lengthy, say 18 to 24 months, the evidence should be conclusive and the loan should be deemed to be a Qualified Mortgage.

The reasoning is straight forward. If a borrower has sufficient funds to regularly make its mortgage payments for 18 to 24 months, the lender has done a reasonable job in reviewing the capacity of the borrower to make the payments. The industry treats borrowers in that way — i.e., if a default occurs after that period (and different lenders use different periods, some as short as 12 months), it is not viewed as an underwriting error. The default occurs at that further point in time because of the occurrence of an unpredictable life event — job loss, death, etc. — not a failure in the review of the loan at inception.

The Official Staff Interpretation, in commenting upon Section 1026.43(c)(1), says:

> The following may be evidence that a creditor's ability-to-repay determination was reasonable and in good faith:
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> 1. The consumer demonstrated actual ability to repay the loan by making timely payments, without modification or accommodation, for a significant period of time after consummation or, for an adjustable-rate, interest-only, or negative-amortization mort-

> gage, for a significant period of time after recast.[1]

Similarly, "the longer a consumer successfully makes timely payments after consummation or recast the less likely it is that the creditor's determination of ability to repay was unreasonable or not in good faith."

These are helpful comments by the Bureau, and certainly are reasonable positions for the Bureau to take. Nevertheless, they are not regulations and are only Staff Interpretations. Similarly, they are open-ended and permit a plaintiff's lawyer to make the case during a motion to dismiss or summary judgment argument that the issue of "how long payments are made" is a question for the jury. Many, if not most, judges would support that argument. That being the case, the litigation risks and the potential costs of judgment remain.

The Bureau should quantify its statement. Only a minimum amount of research would be necessary to provide the Bureau with the ability to modify its comments to state specifically that regular payments of 18 months after origination or recast would be conclusive evidence that the lender satisfied the test of ability to repay. Perhaps its research would show that 12 months or 24 months are better periods. But specifically articulating that period would provide an additional element of good public policy to the regulations.

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[1] Official Staff Interpretation 1026.43(c)(1)-1(ii)(1)