

# Qualified Mortgages and Qualified Residential Mortgages under the Dodd-Frank Act

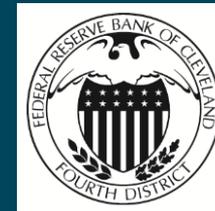
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# Qualified Mortgages (QMs) under the Dodd-Frank Act (DFA)

Proliferation of residential mortgage loans made with little or no underwriting played a significant role in the financial crisis and prompted Congress to impose ability-to-repay (ATR) requirement on residential mortgage lenders



# Qualified Mortgages (QMs) under the Dodd-Frank Act (DFA)

- Lenders have two compliance options: the general ATR standard or the QM standard, which provides certain legal protection
- General ATR standard requires creditor to consider and verify eight underwriting factors:
  - Current or reasonably expected income or assets
  - Employment status
  - Monthly payment on this loan
  - Monthly payment on “simultaneous loans”
  - Monthly payment for “mortgage-related obligations”
  - Current debt obligations
  - Monthly DTI ratio, or residual income
  - Credit history



# Qualified Mortgages (QMs) under the Dodd-Frank Act (DFA)

- For QM standard, 4 different types of QMs:
  - General QM
  - Temporary GSE/federal agency QM
  - Small creditor balloon QM
  - Small creditor QM
- Slide 5 lists the requirements for these QMs
- QMs provide legal presumption of compliance with ATR requirement, while general ATR standard does not
- Strength of legal protection for QMs depends on whether QM is prime or higher-priced



## General Comparison of Ability-to-Repay Requirements with Qualified Mortgages

	ATR Standard	General QM Definition	Agency/GSE QM (Temporary)	Balloon-Payment QM	Small Creditor QM	Small Creditor Balloon-Payment QM (Temporary)
Loan feature limitations	No limitations	No negative amortization, interest-only, or balloon payments	No negative amortization, interest-only, or balloon payments	No negative amortization or interest-only payments	No negative amortization, interest-only, or balloon payments	No negative amortization or interest-only payments
Loan term limit	No limitations	30 years	30 years	No more than 30 years, no less than 5 years	30 years	No more than 30 years, no less than 5 years
Points & fees limit	No limitations	3%	3%	3%	3%	3%
Payment Underwriting	Greater of fully indexed or introductory rate	Max rate in first 5 years	As applicable, per GSE or agency requirements	Amortization schedule no more than 30 years	Max rate in first 5 years	Amortization schedule no more than 30 years
Mortgage-related obligations	Consider and verify	Included in underwriting monthly payment <sup>2</sup> and DTI <sup>3</sup>	As applicable, per GSE or agency requirements	Included in underwriting monthly payment <sup>2</sup> and DTI <sup>3</sup>	Included in underwriting monthly payment <sup>2</sup> and DTI <sup>3</sup>	Included in underwriting monthly payment <sup>2</sup> and DTI <sup>3</sup>
Income or assets	Consider and verify	Consider and verify	As applicable, per GSE or agency requirements	Consider and verify	Consider and verify	Consider and verify
Employment status	Consider and verify	Included in underwriting DTI	As applicable, per GSE or agency requirements	No specific requirement	No specific requirement	No specific requirement
Simultaneous loans	Consider and verify	Included in underwriting DTI	As applicable, per GSE or agency requirements	Included in underwriting DTI	Included in underwriting DTI	Included in underwriting DTI
Debt, alimony, child support	Consider and verify	Consider and verify	As applicable, per GSE or agency requirements	Consider and verify	Consider and verify	Consider and verify
DTI or Residual Income	Consider and verify	DTI ≤ 43 percent	As applicable, per GSE or agency requirements	Consider and verify	Consider and verify	Consider and verify
Credit History	Consider and verify	Included in underwriting DTI	As applicable, per GSE or agency requirements	No specific requirement	No specific requirement	No specific requirement

2 “Included in underwriting monthly payment” means that the rule does not require the creditor to separately consider and verify this factor. However, a creditor must consider this factor when underwriting the consumer’s monthly payment under the rule.

3 “Included in underwriting DTI” means that the rule does not require the creditor to separately consider and verify these factors. However, a creditor considers and verifies these factors when calculating the consumer’s debt-to-income ratio.



# General QM

- Substantially equal, amortizing regular payments
- No negative amortization, interest-only payment, or balloon payment
- Loan term cannot exceed 30 years
- Points and fees cannot exceed 3% of the loan amount
- Underwriting must consider mortgage-related obligations, be based on maximum rate in first five years, and consider and verify income or assets used in making ATR determination
- Back-end DTI cannot exceed 43%, using methodology of Appendix Q of Regulation Z



# Small Creditor QM

- Only applies to “small creditors”
  - \$2 billion or less in assets in preceding calendar year
  - Made 500 or fewer 1<sup>st</sup> lien mortgages in previous calendar year, including affiliates
  - Holds them in portfolio for at least 3 years (with exceptions) and not be subject to forward commitments
- Has same requirements as general QM, except:
  - DTI can exceed 43%
  - Small creditor can charge higher rate for 1<sup>st</sup>-lien mortgage loan (up to 350 basis points over APOR) and still receive safe harbor for compliance with ATR requirement
  - Does not have to follow Appendix Q for calculating DTI



# Small Creditor Balloon QM

- Only applies to “small creditors”
- Same requirements as general QM, except:
  - DTI can exceed 43%
  - Small creditor can charge higher rate for 1<sup>st</sup>-lien mortgage loan (up to 350 basis points over APOR) and still receive safe harbor for compliance with ATR requirement
  - Balloon payment is permitted
  - Loan term must be between 5 and 30 years
  - Must have fixed-rate and monthly amortizing payments (except for final balloon payment)
  - Does not have to follow Appendix Q for calculating DTI
- CFPB originally required creditor to make at least 50% of its mortgages in “rural & underserved areas” but is temporarily waiving requirement until January 10, 2016 while researching the issue because industry said definition was too narrow



# Temporary GSE and Agency QM

- Applies to loans *eligible* to be purchased, insured, or guaranteed by GSEs (while in receivership), FHA, VA, U.S. Dept. of Agriculture, or Rural Housing Service
- Lender must follow GSE/government agency underwriting requirements instead of general QM underwriting requirements
- 43% DTI requirement does *not* apply
- This temporary QM expires for GSEs when Fannie/Freddie receivership ends, or for agencies when they adopt their own QM rule, or January 10, 2021, whichever comes first
- Congress is currently considering legislation to end receivership for Fannie and Freddie



# QM 3% Points and Fees Test

- Points and fees cannot exceed 3% of the total loan amount (amount financed minus certain financed costs included in points/fees) for a loan greater than or equal to \$100,000
- For loans under \$100,000, different limits apply:
  - \$3,000 for loan  $\geq$  \$60,000 but  $<$  \$100,000
  - 5% of total loan amount for loan  $\geq$  \$20,000 but  $<$  \$60,000
  - \$1,000 for a loan  $\geq$  \$12,500 but  $<$  \$20,000
  - 8% of total loan amount for loan  $<$  \$12,500
- These amounts will be adjusted for inflation



# Points and Fees Test (cont.)

- Points and fees include:
  - Finance charges, except interest, PMI, and gov't mortgage insurance premiums (FHA, VA, etc.)
  - Loan originator compensation, except compensation paid by mortgage broker or lender to a loan originator employee
  - Up-front credit insurance premiums
  - Certain real estate-related fee (see 1026.4(c)(7)) unless:
    - charge is reasonable
    - creditor receives no direct or indirect compensation; and
    - charge is not paid to an affiliate of the creditor
  - GSE loan-level price adjustment
  - Maximum prepayment penalty
  - Actual prepayment penalty paid in a refinance
  - Fees paid to affiliates for real estate services



## Points and Fees Test (cont.)

- Points and fees exclude:
  - Bona fide third-party charge not retained by creditor, loan originator or affiliate
  - Up to 2 bona fide discount points
- Creditors must be diligent in calculating points and fees because if the 3% limit is exceeded, mortgage will not receive QM status
- If creditor marketed mortgage as a safe QM, and 3% limit was exceeded, creditor could have legal risk with its regulator and borrower



# Prepayment Penalties

- Prepayment penalties are prohibited for non-QMs, for adjustable rate loans, and for higher-priced loans
- For loans on which prepayment penalties are permitted, limits apply:
  - 2% during 1<sup>st</sup> two years
  - 1% during third year after consummation
  - No penalties allowed after 3<sup>rd</sup> year
- If loans containing prepayment penalties are offered, creditor must also show borrower a loan without the penalty



# Legal Protections of QMs

- Strength of legal protection for QM depends on whether loan is prime or higher-priced. If APR exceeds average prime offer rate (APOR) +150 basis points for 1<sup>st</sup> lien loans or APOR + 350 basis points for subordinate lien loans), loan is higher-priced
- Higher-priced QM receives rebuttable presumption of compliance. A consumer can rebut the presumption by showing that the loan payment did not leave sufficient income or assets to meet required living expenses
- Prime QM receives true safe harbor: it is “conclusively presumed that the creditor made a good faith and reasonable determination of the consumer’s ability-to-repay”
- Small creditor QM and balloon QM allow higher threshold for prime QM: up to 350 basis points + APOR for 1<sup>st</sup>-lien loans



# Legal Implications for QM & Non-QM Loans

- Initial uncertainty likely as borrower's counsel will seek information from lenders regarding underwriting standards to determine whether falls under safe harbor or rebuttable presumption protections (QM) or under general ATR standards (non-QM)
- Courts will have to determine the extent of discovery that will be permitted
- Existing case law involving HOEPA loans and HPMLs may provide guidance
- For non-QM loans, suitability of a borrower for a particular loan will be the legal issue



# Changes to TILA Civil Liability under the Dodd-Frank Act

- Higher damages for violating ability-to-repay (ATR) or loan originator compensation (LOC) requirements: actual damages, twice the amount of the finance charge paid (capped at \$4,000), the sum of all finance charges and fees consumer paid, court costs, and attorney's fees — unless the creditor demonstrates that the failure to comply is not material.
- Statute of limitations extended from one year to three for ATR and LOC violations
- Setoff claims allowed for ATR or LOC violations in foreclosure without regard to statute of limitations



# QMs and Fair Lending Risk

- Creditors have expressed concern that if they only offer QMs, fewer protected-class borrowers may qualify
- Mortgage data indicate that most current mortgages meet QM requirements; however, some targeted loan programs could be affected
- Lenders should consider fair lending implications of offering non-QM loans to high net worth/private banking clients
- Richard Cordray recently observed: “If you're doing solid, responsible lending and you're mindful of the fact that there are fair-lending concerns around it, I don't know that you need to change what you've been doing”



# QMs and Fair Lending Risk

- Historically, most fair lending cases have been based on disparate treatment though agencies consider cases using disparate impact
  - Interagency April 1994 Policy Statement on Discrimination in Lending
  - CFPB April 2012 bulletin indicating they intend to use disparate impact in enforcement
  - HUD February 2013 disparate impact rule
- However, potential for increased use of disparate impact
  - Facially neutral policy or practice that has an adverse impact on a protected group
  - Burden shifts to lender to demonstrate business justification for policy or practice and that less discriminatory policy or practice does not exist
- Pending U.S. Supreme Court case in *Mount Holly v. Mt. Holly Gardens Citizens in Action, Inc.*, may also affect disparate impact issue. Decision expected in 2013-14 court term



# QMs and Fair Lending Risk

- Things to do in preparation for effective date:
  - Identify all sources of mortgage loan originations (internal and external)
  - Determine whether products fall under one of the QM types and protections or is a non-QM loan
  - Determine whether any non-QM loans will be offered and to which borrowers, considering any fair lending implications
  - Ensure you have established robust fair lending risk assessments, fair lending testing, and processes to address any identified risks or instances of potential disparate treatment or impact



# QMs and the Community Reinvestment Act (CRA)

- Creditors have expressed concern that if they only offer QMs, fewer low- and moderate income (LMI) borrowers may qualify, negatively affecting their CRA performance
- Mortgage data indicate that most current mortgages meet QM requirements; however, the availability of some targeted loan programs could be impacted
- Banks should implement robust monitoring of mortgage lending to determine whether there is a decline in performance because of QMs, especially to LMI geographies and borrowers
- Any declines in lending performance should be supported by analysis of relevant demographic and economic data



# QMs and the Community Reinvestment Act (CRA)

- When conducting a CRA evaluation, examiners will consider the bank's performance context and the bank's business strategy
- Banks may want to consider including consumer loan products in its internal CRA analysis and performance evaluation to further demonstrate how loans are made available to the assessment area, especially LMI geographies and borrowers
- Banks may want to consider how community development activities, especially community development loans and investments, can help meet affordable housing needs



# QRMs under the Dodd-Frank Act

- Original proposal issued in 2011
- New proposal issued August 2013 with comments due October 30, 2013
- Proposing QRM = QM for purposes of statutory exception from risk retention requirement
- Seeking comment on alternative “QRM Plus” approach
  - QMs + 1-4 Family Principal Dwelling + First Lien + Credit History Restrictions + LTV not exceeding 70%
  - Excludes GSE/federally guaranteed, small creditor and small creditor balloon loans
  - Fewer loans would be exempt from risk retention requirements under this approach



# Resources

- CFPB Mortgage Rule Page: <http://tinyurl.com/cfpb-MR>
- CFPB Mortgage Implementation Page: <http://tinyurl.com/reg-imp>
- CFPB ATR/QM Compliance Guide: <http://tinyurl.com/CFPB-ATRQM>
- CFPB ATR/QM YouTube video: <http://tinyurl.com/CFPB-QM-video>
- Amended QRM Rulemaking Proposal (Aug. 28, 2013): <http://tinyurl.com/qrm-amended>



# Questions?

