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A legal update from Dechert LLP

U.S. Consumer Financial Protection Bureau in Process of Restructuring Regulation of the Residential Mortgage Market: Qualified Mortgage Rule Emerges as Critical Issue

Under the Dodd-Frank Act, the Consumer Financial Protection Bureau (CFPB) has broad responsibility to regulate the residential mortgage finance industry. The CFPB has recently taken several actions in this area, such as issuing a proposed rule to adopt a new loan estimate form and a new closing disclosure form and announcing that it will issue proposals on mortgage loan originator compensation and on mortgage servicing requirements. However, what may be most important is its current rulemaking to define a “qualified mortgage” (QM) under the Dodd-Frank Act.

Title XIV of the Dodd-Frank Act addresses problems in the U.S. housing mortgage system. A key element of the reforms is an amendment to the Truth in Lending Act (TILA) to ensure that lenders generally do not make residential mortgage loans unless they make a reasonable and good faith determination that the borrower has the ability to repay the loan at the time the loan is made. Lenders can satisfy this requirement by making a QM loan or by making a non-QM loan that satisfies several other underwriting requirements.¹

The Dodd-Frank Act authorizes the Federal Reserve to issue regulations to interpret the QM exemption. The Federal Reserve issued a proposed rule in May 2011, but the Dodd-Frank Act transferred rulemaking responsibility for TILA, including the QM proposal, to the CFPB on July 21, 2011. See our *DechertOnPoint* “[Federal Reserve’s Proposed Rule to Implement the Ability-to-Repay Requirements for Residential Mortgage Loans and its Impact on Lenders and RMBS Investors](#)” (June 27, 2011). On June 5, 2012, the CFPB reopened the comment period through July 9, 2012, in order to receive comment on DTI data provided by the Federal Housing Finance Agency (FHFA) and on potential litigation costs and liability risks associated with making QM loans and non-QM loans.

The QM proposal was the focus of a hearing on July 11, 2012 before the Subcommittee on Financial Institutions and Consumer Credit of the House Committee on Financial Services.

¹ A QM in general terms is a residential mortgage loan that (i) has a term of not more than 30 years, (ii) is fully amortizing, (iii) has a fixed interest rate or, if it has an adjustable rate, the loan is underwritten based on the borrower’s ability to repay the highest permissible interest rate during the first five years of the loan and (iv) has total points and fees that do not exceed 3% of the total loan amount. All applicable taxes, insurance and assessments must be included when determining the borrower’s ability to repay, and all income and financial resources relied on to qualify the borrower must be verified and documented. The Board of Governors of the Federal Reserve System (Federal Reserve) by regulation may revise, add to or subtract from these criteria, such as to add a maximum debt-to-income ratio (DTI) or similar measures or to extend the maximum permissible term of loans made in high-cost areas.

Applying QM Standards in the Real World

Several key points emerged from comments filed with the Federal Reserve and the CFPB during the reopened comment period and from testimony at the hearing:

- **Lenders Are Unlikely to Make Non-QM Loans.** Both industry and community groups expressed concern that lenders will have little interest in making non-QM loans. Non-QM loans are expected to present unacceptable potential litigation costs and liability risks with regard to compliance with the ability-to-repay requirement in TILA, for both originators and assignees (such as purchasers of loans and investors in loan securitizations). Indeed, non-QM lending may be viewed as a reputational risk to lenders.
- **Steering Prohibition.** The Dodd-Frank Act also requires the CFPB to issue regulations to prohibit mortgage originators from steering a loan applicant who is qualified for a QM loan to a non-QM loan.
- **Need for Broad QM Standards.** Based on the concern, for the reasons discussed above, that non-QM financing will be scarce and expensive, witnesses and commenters urged the CFPB to adopt QM standards that would encompass a large percentage of the loans currently being made under post-financial crisis lending standards.
- **Need for Clear QM Standards.** Industry representatives have stressed that, to be effective, the QM standard must be clear, objective and easy to apply, in order that lenders can determine with reasonable certainty before a loan is made whether it will be a QM loan.
- **Reliance on DTI Should Be Limited.** Commenters did not consider a loan applicant's DTI, taken alone, to be a particularly useful indicator of future loan delinquency. Some commenters therefore suggested that the maximum permissible DTI for a QM loan be as high as 50%, in order that the QM standard not be unnecessarily restrictive. They also suggested that, when the DTI cutoff is exceeded, lenders should be permitted to consider a sequence or "waterfall" of additional loan criteria, such as loan-to-value ratio or the borrower's residual income, in determining whether a loan is a QM loan.
- **Safe Harbor vs. Rebuttable Presumption.** The Federal Reserve left open in its proposed rule the issue of whether compliance with the objective criteria of a QM standard should be a safe harbor

from liability or should only create a rebuttable presumption that a borrower has the reasonable ability to repay a loan. Industry witnesses and commenters insisted that only a safe harbor would have the intended effect of ensuring that residential mortgage financing would be readily available.

- **Income vs. Assets.** While the QM proposal provides that a borrower's income or assets may be used to establish his or her ability to repay, if a final rule includes a maximum permissible DTI and does not take a borrower's assets into account, it may present significant issues. It could raise the possibility that retirees and other persons who may be more reliant on assets than income to support their ability to repay may have difficulty being approved for a QM loan. If applicants in these groups cannot readily meet the QM standard, they may have limited access to residential mortgage financing of any type, which may in turn adversely affect housing markets that rely extensively on retiree purchasers.
- **Fair Lending Concerns.** To the extent that lenders migrate toward making QM loans in order to comply with the Dodd-Frank Act's ability-to-repay requirement, their ability to customize mortgage products may become more limited. Applicants with damaged credit or less well documented financial resources are more likely to be denied credit or offered only higher-cost non-QM loans. Commenters have asked the CFPB to provide guidance as to how compliance with ability-to-repay requirements and anti-discriminatory lending requirements can be reconciled and liability for fair lending law violations can be avoided.

Timing Uncertainty

An additional issue raised by the CFPB's decision to reopen the comment period is the effect it may have on the effective date of the ability-to-repay provisions of the Dodd-Frank Act. The Dodd-Frank Act provides that all sections of Title XIV for which implementing regulations have not been issued as of January 21, 2013 will take effect on that date. The Dodd-Frank Act further provides, if an implementing regulation has been issued for a section of Title XIV by that date, that section or a provision thereof will not take effect until the regulation takes effect, which will be 12 months after the date the regulation is issued. Some industry representatives have expressed concern that the CFPB may not be able to consider the comments it has received during the reopened comment period and complete work on a QM

final rule by January 21, 2013, making the effective date of the ability-to-repay provisions uncertain. The CFPB has stated that it expects to have a QM final rule in place before the end of 2012.

Applying QM Standards to Risk Retention

Another issue is the relationship of the QM requirements to the credit risk retention requirements under Title IX of the Dodd-Frank Act. Section 941 of the Dodd-Frank Act generally requires the securitizers of asset-backed securities to retain at least 5% of the credit risk of the relevant assets, and directs the federal banking agencies (the Federal Reserve, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency) and the Securities and Exchange Commission (SEC) to prescribe how this requirement will apply to the securitizers and originators of residential mortgage-backed securities. However, the Dodd-Frank Act further provides that the risk retention requirement does not apply if the relevant assets are qualified residential mortgages (QRM). The federal banking agencies, the SEC, the FHFA and the Department of Housing and Urban Development are directed to define what a QRM loan is, but their definition cannot be any broader than the definition of a QM loan.

The six federal financial agencies issued a joint proposed credit risk retention rule for residential mortgage assets, which appeared in the Federal Register on

April 29, 2011. See our *DechertOnPoints* “[Risk Retention Proposal for Residential Mortgages Comes into Focus](#)” (May 23, 2011) and “[Risk Retention and Residential Mortgages: Legislation, Regulation and Economics](#)” (April 1, 2011). The proposed rule included a QRM definition, and the notice of proposed rulemaking included an extensive discussion of the proposed criteria for a loan to qualify for the QRM exemption. The six federal financial agencies extended the comment period on the proposed rule until August 1, 2011, and received several hundred comments and held several dozen meetings with commenters.

As with the QM proposal, commenters expressed concern that a narrow QRM exemption could significantly restrict the availability of housing finance in the United States. The federal financial agencies have indicated that they will wait for a QM final rule to be issued before completing work on the QRM exemption.

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