American Bankers Association Real Estate Lending Conference

Qualified Mortgages:

A Sea Change For Mortgage Lenders

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The Qualified Mortgage (QM) Rule

QM Rule

- To be a QM, a loan must meet certain requirements
  - As a general matter, regular periodic payments that are substantially equal, except for interest rate adjustments, that do not result in negative amortization, do not generally allow deferral of principal repayment, or result in a balloon payment subject to certain exceptions
  - May not have excessive points and fees (those exceeding 3% of the total loan amount for a loan of $100,000)
  - A term of no longer than 30 years
  - Creditor underwrites the loan, using maximum interest rate during the first five years of the loan, and periodic payments of principal and interest that will repay the loan within its term subject to assumptions regarding an adjustable loan
  - Creditor considers and verifies at or before consummation –
    - Consumer's current or reasonably expected income or assets other than value of security property in accordance with the ATR Rule, and
    - Consumer's current debt obligations, alimony, and child support in accordance with the ATR Rule

QM Rule

- To be a QM, a loan must meet certain requirements (cont.)
  - Borrower's total monthly DTI ratio may not exceed 43%
    - DTI generally determined in accordance with Appendix Q
      - Creditor must include the following when calculating DTI for recurring obligations
        - Monthly housing expense (taking into account payment levels calculated under QM Rule and any simultaneous loans)
        - Recurring charges lasting 10 months or more, such as: payments on installment accounts, child support or maintenance payments, revolving accounts, and alimony
        - Debts lasting less than 10 months must be included if amount of debt affects consumer's ability to pay the mortgage during the months immediately following closing, but must include monthly payments on revolving or open-end accounts even if account appears likely to be paid off within 10 months or less

QM Rule

- To be a QM, a loan must meet certain requirements (cont.)
  - Impact of DTI ratio requirement
    - Bureau recognizes that a maximum DTI ratio for QMs will exclude some loans that constitute responsible lending
    - Notes that in current market 22% of the mortgage loans are made with DTI ratios exceeding 43%
    - Fears that if QM standard covers substantially all of the mortgage market, creditors might be unwilling to make non-QMs, and as result, QM Rule would define the limit of credit availability
    - Expects that as credit conditions ease, creditors will continue making prudent loans in non-traditional segments, such as
      - Consumers who have sufficient total assets or future earning potential to be able to afford a loan with a higher DTI
      - Consumers who have a demonstrated ability to pay housing expenses at or above the level of a contemplated mortgage
    - Bureau expects that many non-QM qualifying loans will qualify for the temporary exceptions provided under the QM Rule

QM Rule

- Temporary Exception for Government and GSE-Eligible Loans
  - Do not meet 43% DTI limit
  - Loan must meet following requirements
    - As a general matter, regular periodic payments that are substantially equal, except for interest rate adjustments, that do not result in negative amortization, do not generally allow deferral of principal repayment, or result in a balloon payment subject to certain exceptions
    - May not have excessive points and fees (those exceeding 3% of the total loan amount for a loan of $100,000)
    - A term of no longer than 30 years

QM Rule

- Temporary Exception for Government and GSE-Eligible Loans (cont.)
  - Eligible to be purchased, guaranteed, or insured (as applicable) by certain government agencies or GSEs
    - Fannie Mae and Freddie Mac (while they remain in conservatorship)
    - Department of Housing and Urban Development
    - Department of Veterans Affairs
    - Department of Agriculture
    - Rural Housing Service

QM Rule

- Temporary Exception for Government and GSE-Eligible Loans (cont.)
  - Loan need not actually be purchased, guaranteed or insured, only must be eligible for such a transaction
    - This includes satisfying any requirements regarding consideration and verification of income or assets, credit history, and DTI ratio or residual income
    - May rely on Fannie Mae or Freddie Mac's automated underwriting system
  - Exception ends January 10, 2021
  - Subject to either safe harbor or rebuttable presumption based on pricing

QM Rule

- QM Safe Harbor Loans
  - First lien loans on a covered transaction which have an interest rate of less than 1.5% (or 3.5% for subordinate lien loans) higher than the average prime offer rate available in the vicinity
  - Meet all QM requirements
  - Deemed to comply with the ATR requirements
  - To challenge, a borrower would have to prove a loan was not a QM

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QM Rule

- QM Rebuttable Presumption Loans
  - First lien loans on a covered transaction which have an interest rate of 1.5% (or 3.5% for subordinate lien loans) or higher than the average prime offer rate available in the vicinity
  - Meet all QM requirements
  - Presumed that lender satisfied the ATR requirements

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QM Rule

- QM Rebuttable Presumption Loans (cont.)
  - Consumer must prove that despite meeting QM requirements
    - the creditor did not make a reasonable and good faith determination of the consumer's ATR at the time of consummation
    - by showing that the consumer's income, debt obligations, alimony, child support, and consumer's monthly payment obligations on the covered transaction and any simultaneous loans of which lender was aware at consummation
    - would leave the consumer with insufficient residual income or assets (other than the secured property) to meet living expenses, including any recurring and material non-debt obligations of which the creditor was aware at the time of consummation

Small Creditor QM Proposal

- Creditor Requirements
  - Creditor had total assets of $2 billion at end of prior calendar year
  - Together with all affiliates originated 500 or fewer covered transactions
- Loan Requirements
  - Must meet all QM requirements except for 43% DTI maximum
  - Small creditor would still have to verify consumer's income and assets and consider DTI ratio and residual income

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Small Creditor QM Proposal

- Loan would lose its QM status if it is held in portfolio for less than three years, subject to certain exceptions
- CFPB views regarding small creditor “relationship” lending
- QM safe harbor would be available to small creditors and small rural creditors on qualifying loans that are up to 3.5 percentage points above the average prime offer rate on first and subordinate lien loans

The Ability-to-Repay (ATR) Rule: What It Says and What It Means

ATR Rule

- ATR Requirement operational language
  - ***A creditor shall not engage in a covered transaction unless the creditor makes a reasonable and good faith determination at or before consummation that the consumer will have a reasonable ability to repay the loan according to its terms***
  - Bureau commentary provides guidance
    - Whether an ATR is reasonable and in good faith will depend not only on the creditor's underwriting standards but on the facts and circumstances of a particular extension of credit and how a creditor's standards were applied to those facts and circumstances

ATR Rule

- Underwriting Requirements
  - Lenders can set their own underwriting standards
    - Standards must be applied consistently
    - Lenders may reference guidance issued by FHA, the VA, or Fannie Mae and Freddie Mac (while they remain in conservatorship)
  - Unlike QM Rule, ATR rule does not mandate a maximum DTI
  - Creditor may determine standards for DTI or monthly residual income in making a good faith determination of a consumer’s ATR

ATR Rule

- Underwriting Requirements (cont.)
  - Compensating factors
    - Creditor may consider factors in addition to DTI or residual income
    - Creditor may determine that a consumer has ATR despite high DTI or low residual income in light of the consumer's assets, including savings accounts
    - Creditor may determine that a consumer has ability to repay despite a higher DTI in light of the consumer's residual income

ATR Rule

- ATR Requirement (cont.)
  - Bureau commentary provides guidance
    - Factors that may be evidence that a consumer's ATR was <u>reasonable and in good faith</u>
      - Consumer demonstrated actual ability to repay the loan by making timely payments for a significant period of time after consummation or after recast
      - Creditor used underwriting standards that have historically resulted in comparatively low rates of delinquency and default during adverse economic conditions
      - Creditor used underwriting standards based on empirically derived, demonstrably and statistically sound models

ATR Rule

- ATR Requirement (cont.)
  - Bureau commentary provides guidance
    - Factors that may be evidence that a consumer's ATR was <u>not reasonable or in good faith</u>
      - Consumer defaulted on the loan a short time after consummation or, a short time after recast
      - Creditor used underwriting standards that have historically resulted in comparatively high levels of delinquency and default during adverse economic conditions
      - Creditor applied underwriting standards inconsistently or used underwriting standards different from those used for similar loans without reasonable justification

ATR Rule

- ATR Requirement (cont.)
  - Bureau commentary provides guidance
    - Factors that may be evidence that a consumer's ATR was not reasonable or in good faith (cont.)
      - Creditor disregarded evidence that the underwriting standards it used are not effective at determining consumers' repayment ability
      - Creditor disregarded evidence that consumer may have insufficient residual income to cover recurring obligations and expenses, taking into account consumer's assets other than the security property, after making monthly payments for the covered transaction, any simultaneous loans, mortgage-related obligations, and any current debt obligations
      - Creditor disregarded evidence that the consumer would have the ability to repay only if the consumer subsequently refinanced the loan or sold the property

ATR Rule

- ATR Requirement (cont.)
  - Bureau commentary provides guidance
    - No bright lines for determining whether there was a reasonable and good faith ATR determination
    - None of the preceding factors are requirements with which creditors must comply, nor are they elements of a claim that the **borrower must prove** to establish an ATR violation
    - Inconsistent application of underwriting standards may indicate that a creditor is manipulating those standards to approve a loan despite a consumer's inability to repay

ATR Rule

- ATR Requirement (cont.)
  - Bureau commentary provides guidance
    - Early payment default will often be persuasive evidence that the creditor did not have a reasonable and good faith belief in the consumer's ATR, but notes that a particular determination may be reasonable and good faith, for example, the consumer experienced a sudden and unexpected loss of income
    - ATR determination may be unreasonable and not in good faith even though consumer made payments for a significant period of time if, for example, the consumer was able to make payments only by foregoing necessities such as food and heat

ATR Rule

- ATR Requirement (cont.)
  - Bureau commentary provides guidance
    - Consumer's ATR is to be determined at or before the time the loan is consummated
    - A change in circumstances that cannot reasonably be anticipated from a consumer's application or records use for the ATR determination (such as a significant reduction in income due to job loss or a major medical expense) is not relevant to determining a creditor's compliance with the ATR Rule
    - If application or records considered by the creditor at or before the loan indicate there will be a change in consumer's repayment ability after consummation (such as a plan to retire or to transition from full to part time employment), creditor must consider that information under the ATR Rule
    - ATR Rule does not require or permit creditor to make inquiries or verifications prohibited by Regulation B

QM Rule

- QM Rebuttable Presumption Loans
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  - Meet all QM requirements
  - Presumed that lender satisfied the ATR requirements

QM Rule

- QM Safe Harbor
  - First lien loans on a covered transaction which have an interest rate of less than 1.5% (or 3.5% for subordinate lien loans) higher than the average prime offer rate available in the vicinity
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Liability for Failure to Comply with the ATR and QM Rules

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Liability for Failure to Comply with the ATR Rule

- General Truth in Lending Act damages
  - Actual damages
  - Statutory damages
  - Attorneys fees and costs
- Special ATR statutory damages
  - Up to sum of all finance charges and fees paid by consumer, unless creditor demonstrates the failure was not material
- Foreclosure provision
  - When a creditor, or an assignee or other holder initiates a foreclosure action, a consumer may assert an ATR violation as a matter or defense by recoupment or setoff
  - No time limit on the use of this defense

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Legal Implications for Non-QM Loans

- For non-QM loans rules bring a big change in relative positions between borrower and lender
- Suitability of a borrower for a particular loan will be a recognized legal issue
- Significant initial uncertainty likely as borrower counsel seek extensive discovery from lenders regarding non-QM underwriting standards
- Courts will have to determine the extent of discovery that will be permitted
- Potential for significant expense and delay

Legal Implications for Non-QM Loans

- Courts will have to determine how they will evaluate substantive ATR issues in absence of definitive Bureau guidance
- High potential for inconsistent rulings
- Could result in lengthy appeals that may focus both on lender underwriting standards and particular borrower circumstances
- At least initially these factors could favor borrowers and encourage negotiated resolutions, including loan modifications

Legal Implications for QM Rebuttable Presumption Loans

- Consumer must prove that despite meeting QM requirements
  - the creditor did not make a reasonable and good faith determination of the consumer's ATR at the time of consummation
  - by showing that the consumer's income, debt obligations, alimony, child support, and consumer's monthly payment obligations on the covered transaction and any simultaneous loans of which lender was aware at consummation

Legal Implications for QM Rebuttable Presumption Loans

- Consumer must prove that despite meeting QM requirements (cont'd)
  - would leave the consumer with insufficient residual income or assets (other than the secured property) to meet living expenses, including any recurring and material non-debt obligations of which the creditor was aware at the time of consummation

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Legal Implications for QM Rebuttable Presumption Loans

- For QM rebuttable presumption loans, lender will have to be prepared to demonstrate that the borrower would have sufficient residual income to pay the mortgage loan
- This will involve discovery regarding the processing of a loan and the underwriting analysis applied to the individual loan
- Could require comprehensive understanding of borrower spending patterns

Legal Implications of QM Safe Harbor Loans

- For QM safe harbor loans borrower counsel may seek discovery to demonstrate that some aspect of the QM requirements were not met
  - Limit on points and fees
  - 43% DTI maximum
- Thus at least initially this could result in delay and expense even in regard o QM safe harbor loans
- If a QM safe harbor is not available, borrower presumably will pursue an ATR analysis

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Legal Implications of QM Safe Harbor Loans

- What Does the Safe Harbor Mean in the Real World?
  - It may add little initially
    - Borrower counsel seek extensive discovery from lenders trying to demonstrate a QM loan is not a QM loan
    - Courts will have to determine extent of discovery that will be permitted
    - Potential for significant expense and delay that undercuts the reason for a safe harbor
  - Safe harbor loans like all loans will be subject to the new loan servicing rules which could substantially increase foreclosure time lines

The New World of Fair Lending Seen Through the ATR Prism

Fair Lending Issues Related to New Rules

- Most fair lending have been based on disparate treatment claims
  - Claim that similarly qualified members of a protected group are treated less favorably as to loan approval or pricing than majority group members
- What is the disparate impact theory of liability
  - Agencies take the position that violations of Equal Credit Opportunity Act and Fair Housing Act can be proven through disparate impact analysis
  - "Facially neutral" policy or practice that has a disparate adverse impact on members of a protected group

Fair Lending Issues Related to New Rules

- Once such an impact is demonstrated burden shifts to lender to demonstrate a legally sufficient justification for the challenged practice
  - interests could not be served by another practice that has a less discriminatory effect
  - Challenging party can still prevail by showing that practice with a less discriminatory effect could be used

Fair Lending Issues Related to New Rules

- Potential Impacts of ATR and QM Rules on Lending Patterns
  - Decrease in availability of non-QM loans may disproportionately affect low-income populations and certain geographic areas
  - Requirement that underwriting standards be applied consistently could impact lender programs to reach underserved populations through non-QM loans

Fair Lending Issues Related to New Rules

- Potential Impacts of ATR and QM Rules on Lending Patterns (cont'd)
  - Increased risk and liability for lenders for any loans (non-QM and QM rebuttable presumption) that are ultimately subject to challenge
  - Mitigation of initial impact associated with temporary exceptions

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Fair Lending Issues Related to New Rules

- Impact on Fair Lending Theories
  - To date, fair lending claims have overwhelming been based on disparate **“treatment”** claims
  - Claim that similarly qualified members of a protected group are treated less favorably than majority group members may increase
  - Disparate **“impact”** theories become sustainable with higher rates of declination among protected groups

Disparate Impact Developments

- 2012 DOJ settlement with Luther Burbank Savings
  - Institution had a general $400,000 minimum loan policy
  - DOJ took the position that this policy had a disparate impact on availability of mortgage loans to minority group borrowers and was not justified by business necessity or legitimate business considerations
  - Case was settled. Burbank agreed to use a $20,000 minimum loan amount policy

CFPB & HUD View of Fair Lending

- CFPB issued a bulletin in April 2012 indicating that it plans to use disparate impact analysis in its enforcement of ECOA
- HUD issues a “disparate impact” rule under the Fair Housing Act in February 2013
  - Codifies application of disparate impact burden shifting analysis in FHA cases
  - HUD declines to provide assurance to lenders regarding use of credit scoring, debt-to-income ratios or compliance with Dodd-Frank provisions including QM rules

Other Fair Lending Developments

- American Bankers Association has objected to use of disparate impact analysis in fair lending enforcement in a 2012 letter to Fed Chairman Bernanke
- Supreme Court was scheduled to hear St. Paul, Minnesota challenge to the use of disparate impact under the FHA last term but appeal was withdrawn
- Supreme Court may hear a similar challenge by Mount Holly, New Jersey this term

Issues Under the New Rules

- A lender decides to limit its mortgage lending to QM safe harbor loans
- A lender decides to limit its mortgage lending to QM safe harbor loans and QM rebuttable presumption loans
- A lender decides to limits its mortgage lending to QM safe harbor, QM rebuttable presumption loans, and non-QM loans only to borrowers that have high net worth

ATR and the Mortgage Securitization Market Response

Securitization Issues

- Impact of ATR and QM Rules on Securitization
  - Will the securitization market be limited to QM safe harbor loans, or will it extend to QM rebuttable presumption loans or to non-QM loans?
  - Potential liability and borrower defenses may impact securitizations not limited to QM safe harbor loans
  - How may the new rules impact the value of mortgage collateral?

Risk Retention Proposal

- Dodd-Frank requires agencies to issue risk retention rules for asset backed securities, including mortgage backed securities
  - Proposed rules issued in April 2011
  - “Securitizers” will generally be required to retain an economic interest equal to at least 5% of the aggregate credit risk of the assets collateralizing the ABS
  - The proposal would treat Fannie Mae and Freddie Mac guarantees as satisfying the risk retention requirements

QRM Exception

- Qualified Residential Mortgage (QRM) Exception
  - QRM exception allows securitizer to avoid risk retention requirement
  - To be issued by FRB, OCC, FDIC, SEC, HUD and the FHFA
  - QRM exception cannot be any broader than the Bureau's QM standards
  - Agencies had been waiting for QM rule to be issued to issue a final risk retention rule that takes account of the Bureau's rule

QRM Exception

- Qualified Residential Mortgage (QRM) Exception
  - 20% downpayment requirement
  - 80% loan to value ratio
  - Monthly housing debt to monthly gross income does not exceed 28%
  - Monthly total debt to monthly gross income does not exceed 36%
  - Industry representatives and consumer groups have expressed concern regarding the relatively strict requirements for QRM status

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