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MORTGAGES

The State of Play of Qualified and Non-Qualified Mortgages

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Smaller financial institutions that originate residential mortgage loans to hold for investment would be relieved from compliance with the federal ''ability to repay'' requirements by classifying such loans as ''qualified mortgages,'' under the Senate's recently passed banking reform bill, S.2155. This Senate Bill is one indication of the continued interest of the residential mortgage industry to try to maneuver within the regulatory labyrinth of the ''ability to repay'' requirements. Some have found a way as evidenced by last year's increase in private label securitizations of ''non-qualified mortgages.'' Others continue to look for opportunities, as shown by the significant industry response to last year's request by the Consumer Financial Protection Bureau for information on proposed changes to the ''ability to repay'' regulations.

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By this point, the story of ''qualified mortgages'' and ''non-qualified mortgages'' is relatively well known. As part of the ''never again'' mantra following the advent of the financial crisis, legislators and regulators focused on the adverse consequences of extending credit to homeowners whose income perhaps could not support the amount of new debt but whose homes kept appreciating so quickly that a cash-out refinancing could be justified based solely on the perceived value of the property. When home prices came tumbling down, borrowers could not refinance based on the decreased value of their homes and in many instances could not afford the regularly scheduled payments on their loans. A home foreclosure Armageddon quickly followed. Enter the Dodd-Frank Act (''DFA'') in 2010.

What Are the Ability to Repay Requirements?

The DFA imposed an obligation on residential mortgage lenders, with certain exceptions, to make a reasonable, good faith determination of an applicant's ability to repay a loan based on verified, documented information. This ''ability to repay'' or ''ATR'' requirement includes consideration of such items as a mortgage applicant's assets or income, debt load, and credit history. The civil liability provisions of the Truth in Lending Act (''TILA'') apply to violations of this statutory obligation.

A creditor and a subsequent holder or assignee of the loan are subject to four types of monetary damages: actual damages; statutory damages in the amount of $4,000 per loan, without regard to actual damages (with a cap on class actions); a refund of finance charges, such as interest and certain closing costs paid, unless the creditor demonstrates that the violations were not material; and attorneys' fees. A borrower in foreclosure may claim these damages against a subsequent holder of the loan seeking to enforce the loan documents.

The statute and the accompanying regulations create a so-called ''safe harbor'' against ATR liability for certain types of residential mortgage loans called ''Qualified Mortgages'' or ''QM.'' If a residential mortgage loan rises to the level of a QM loan, then the law conclusively presumes that the lender has met its legal obligation to determine the borrower's ability to repay that loan. The borrower can challenge whether the loan in fact constitutes a QM loan, but, assuming the loan meets this standard, that is the end of the inquiry—with one caveat. If the interest rate on the QM loan exceeds a certain amount, then the conclusive presumption for such higher cost loan converts into a rebuttal one, meaning that the borrower has the legal right to challenge the lender's satisfaction of the ATR requirements. In this case, however, the only way the borrower may overcome or rebut the presumption is if the borrower can show that he or she has insufficient income left over to meet living expenses after making all mortgage related payments. A residential mortgage loan subject to the ATR that is not a QM loan logically is called a Non-QM loan.

The ATR requirements only apply to first- or second-lien, consumer purpose, closed end, residential mortgage loans, excluding reverse mortgage loans, construction loans, home equity lines of credit or HELOCs, temporary bridge loans, and time share plans.

What Makes a Loan a QM Loan?

To wear the mantle of a QM loan, three types of eligibility criteria must be satisfied: a numerical points and fees test; a product type and loan features test; and what principally is an underwriting test. First, by statute, a QM loan must not require the up-front payment by the borrower of total points and fees in excess of 3% of the loan. Why Congress imposed a cost standard in the first place is not clear, since such a standard is not directly related to a borrower's ability to make his or her monthly payments on a sustainable basis. The calculation of what is in and what is out of the 3% test has been the subject of much confusion.

Second, a QM loan cannot be of a type or have the features that Congress at the time considered to be inherently risky and a contributing factor to the financial crisis, consisting of interest only loans, balloon loans (and other non-regularly amortizing loans), negative amortization loans, adjustable rate mortgage loans with an initial fixed interest rate of less than five years, and loans with a term of over 30 years. In addition, a QM loan either has to be eligible for sale to Fannie Mae or Freddie Mac, or be eligible for insurance by the Federal Housing Administration or guaranty by the Department of Veterans' Affairs or the Department of Agriculture. For loans that are not government-insured or -guaranteed or conventional conforming, a QM loan must meet the underwriting criteria specified in Appendix Q to the ATR regulations and have a debt-to-income (''DTI'') ratio of 43% or less.

Because of the loan size restrictions for the government and government-related entities, jumbo loans may qualify for QM status only if they meet the Appendix Q/43% DTI requirements. It is also worth noting that the QM rules do not have a down payment requirement, which was a hotly debated topic at the time that the CFPB wrote the QM rules. The criterion that the loan is eligible for sale to Fannie Mae or Freddie Mac is a temporary one. It expires on the earlier of the date the entities come out of conservatorship or January 10, 2021; this time-sensitive exception often is referred to as the ''patch'' and was controversial among many participants in the mortgage industry because it appeared to give Fannie Mae and Freddie Mac yet another leg up on their competition.

The stakes were raised when the multi-agency U.S. credit risk retention rules adopted the QM definition as their definition of Qualified Residential Mortgage Loan or QRM, which dictates whether a sponsor of a securitization of mortgage loans must retain a 5% interest in the related mortgage-backed securities or whether the securitization is exempt from these rules. Securitizations of QRM loans are exempt from U.S. credit risk retention rules.

How Does a Non-QM Loan Satisfy the ATR Requirements?

The law requires a creditor at a minimum to consider the following eight underwriting factors to satisfy the ATR requirements:

- Current or reasonably expected income or assets
- Current employment status
- Monthly payment on covered transaction
- Monthly payment on simultaneous loan
- Monthly payment for mortgage-related obligations
- Current debt obligations, alimony, child support
- Monthly debt-to-income ratio or residual income
- Credit history

The statute and related regulations do provide some insight on these requirements. Yet they do not dictate the required relationship between and among the eight factors, including how to weight one versus the other, nor does it explain what level of consideration is sufficient.

What Is the State of the Non-QM Market?

At the time of this writing, the Non-QM market is segmented. There are what are often referred to as ''Non-QM Lite'' loans, which are jumbo loans that generally would qualify for delivery to the GSEs but for loan size or with other minor variations, and therefore are Non-QM loans simply because they are not eligible to take advantage of the GSE patch. And then there are gradations based on the perceived creditworthiness of the borrower and the degree of structural variation. Except for the Non-QM Lite segment, the Non-QM market has been somewhat slow to develop. Part of the reluctance stems from an inability to determine in advance with legal certainty whether a lender's underwriting guidelines comply with the legal requirements for ATR, unless one follows the guidelines in Appendix Q to the

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regulations. In the early days of the development of the Non-QM market, mortgage loan originators frequently petitioned the Consumer Financial Protection Bureau or CFPB for guidance on loans outside of the Appendix Q guidelines that nevertheless would satisfy the ATR requirements. The CFPB did not issue the requested guidance, which was assumed by some to be intentional silence deferring to the market to see what standards would develop—more on this topic below under the heading ''**What Are the Prospects for Regulatory Reform of the ATR Requirements?**''

The consequence of this combination of high legal risk for violations and high ambiguity for compliance is low production of Non-QM loans. Many lenders to date either have been unwilling to make Non-QM loans or, if they are willing, have found it hard to procure reasonably priced sources of financing. Many financing sources were uncomfortable financing Non-QM loans for fear that they would inherit difficult-to-remarket loans should they need to repossess collateral from a defaulted financing facility. This concern among financing sources is directly caused by the above-noted broad assignee liability imposed by the QM rules. Little wonder that there has been some skittishness in the market given the aggressive government enforcement against financial institutions since the advent of the financial crisis.

In addition to perception of heightened legal risk, simply finding Non-QM borrowers purportedly has been challenging. Unlike the subprime days where eligible borrowers may have spurned government-insured or -guaranteed loans or conventional conforming loans to avoid the documentation requirements, Non-QM applicants have no such luxury. And the higher interest rates typically found on Non-QM loans may repel some otherwise eligible borrowers. Also, rules standardizing loan origination compensation paid to loan officers may have also stunted the growth of the Non-QM market because, in general, the time and effort spent by a loan officer to originate a Non-QM loan is significantly more than the time and effort necessary to originate a conventional conforming mortgage loan. Why work harder for the same result?

Nevertheless, there are buyers and sellers and financiers of Non-QM loans. In 2017, for example, three issuers—Verus, Deephaven and Angel Oak—collectively undertook six private label securitizations of Non-QM loans, and there have been many other private transactions. And the interest among state chartered, non-depositories and private funds to join the Non-QM crowd is increasing. Generally, they believe that the risks of Non-QM lending are overblown and can be prudently managed.

What Are the Prospects for Regulatory Reform of the ATR Requirements?

At the very time there appears to be increased interest in the Non-QM market, there are efforts underway that may expand the number of loans that would fit within the QM box or otherwise be relieved of compliance with the ATR requirements. There are both statutory and regulatory initiatives to ''reform'' the ATR requirements. On the legislative side, Senate Bill 2155, passed on March 14th , 2018, excludes from the ATR requirements smaller financial institutions that originate loans to hold in portfolio, subject to certain limitations. The theory is that these institutions have ''skin in the game'' for potential credit losses by virtue of holding loans in portfolio, and thus they have more incentive to underwrite prudently than those that follow an ''originate-to-distribute'' model. Other legislative efforts seek to revise and simplify the definition of ''total points and fees'' to lessen the likelihood that lenders with QM-compliant underwriting standards do not fall into the Non-QM world simply because of cost of the loan.

In June 2017, the CFPB issued a Request for Information Regarding Ability-to-Repay/Qualified Mortgage Rule Assessment (''RFI''), pursuant to the provision in DFA requiring the Bureau to re-assess within five years of becoming effective each significant rule or order adopted by the Bureau under federal consumer financial law. It made clear at that time that the assessments are for informational purposes only and not part of any formal or informal rulemaking. Nevertheless, there are extensive comments that shed light on potential changes, particularly given the change of control of the CFPB.

The CFPB has extraordinary authority to play with the definition of a QM loan. Under the DFA, the CFPB ''may prescribe regulations that *revise, add to, or subtract from* the criteria that define a qualified mortgage upon a finding that such regulations are necessary or proper to ensure that responsible, affordable mortgage credit remains available to consumers in a manner consistent with the purposes of this section, necessary and appropriate to effectuate the purposes of this section and section 129B, to prevent circumvention or evasion thereof, or to facilitate compliance with such sections.'' In an era of deregulation, it would not be surprising to see the CFPB use this authority to expand the definition of a QM.

It is useful to look at the origins of the ATR requirements when considering what types of changes may be feasible in the future.

On What Are the Ability to Repay Requirements Based?

The genesis of the ATR requirements may be found in the 1994 Home Ownership Equity Protection Act (''HOEPA''), which amended TILA. HOEPA prohibits a creditor from engaging in a pattern or practice of extending credit to consumers under ''high cost'' mortgages (determined by a loan's interest rate and total points and fees) based on the consumer's collateral without regard to the consumer's repayment ability, including the consumer's current and expected income, current obligations, and employment. The civil liability provisions for violations of ATR and HOEPA are very similar—the same type of monetary damages and a defense to foreclosure against the original creditor and subsequent holders.

One major difference, however, is that the assignee liability provisions of HOEPA extend to all claims and defenses with respect to the mortgage that the consumer could assert against the creditor, and not simply those based on a violation of HOEPA; another is that affirmative claims by borrowers are not authorized under the ATR but there are different points of view of whether such claims are available under HOEPA. In addition, in the early 2000s, many states passed their own state law equivalents of HOEPA, called mini-HOEPA laws, that generally had lower financial triggers to try to expand the universe of loans to which the substantive prohibitions applied. In all three cases, the imposition

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of some form of assignee liability is intended to nullify the effects of the ''holder in due course'' doctrine under Article 3 of the Uniform Commercial Code, which, subject to certain exceptions, permits subsequent holders of negotiable instruments to take free of claims and defenses of the obligor against the original creditor.

Extending HOEPA's federal prohibition against lending based on the value of the home rather than on the creditworthiness of the borrower found voice in H.R. 3915—the Mortgage Reform and Anti-Predatory Lending Act of 2007 passed by the House of Representatives but not the Senate in the 110th Congress. Many do not remember this bill, but it imposed an explicit federal duty of care on mortgage loan originators ''with respect to each consumer seeking or inquiring about a residential mortgage loan, diligently [to] work to present the consumer with a range of residential mortgage loan products for which the consumer likely qualifies and which are appropriate to the consumer's existing circumstances, based on information known by, or obtained in good faith by, the originator.'' A residential mortgage loan would be presumed to be appropriate for a consumer if the mortgage originator determined in good faith, based on then-existing information and without undergoing a full underwriting process, that the consumer had a reasonable ability to repay and, in the case of a refinancing of an existing residential mortgage loan, received a net tangible benefit, as determined in accordance with regulations to be prescribed by the federal banking agencies. Last, to qualify for the presumption, the loan could not have predatory characteristics or effects (such as equity stripping and excessive fees and abusive terms) as determined in accordance with those regulations to be issued.

Separately, H.R. 3915 also imposed minimum standards for underwriting in which it repeated the requirement to determine both the borrower's reasonable ability to repay the loan and, in the case of a refinancing, the provision of a net tangible benefit to the borrower. Creditors, assignees and ''securitizers'' were presumed to satisfy these requirements if the loans were ''qualified mortgages'' or ''qualified safe harbor mortgages,'' the definitions of which were similar to what is now the definition of a ''higher cost'' loan and a ''qualified mortgage,'' respectively. The 3% limit on total costs and fees was not part of either of these original definitions.

The proposed law distinguished between creditors, on the one hand, and assignees and securitizers, on the other hand, relative to rebutting the presumption of compliance. Against the former, the presumption was rebuttable, but only as to ''qualified safe harbor mortgages.'' H.R. 3915 did not provide that the presumption could be rebutted either for ''qualified mortgages'' or against assignees and securitizers. This means, for example, if an assignee could prove that a loan was a ''qualified mortgage,'' the borrower could not raise an ATR claim.

The same types of monetary damages available to be sought for violations of the existing ATR statute were part of H.R. 3915, although civil liability was limited to individual actions. In addition, the Bill added a remedy for the rescission of the loan, and recovery of such additional costs as the obligor may have incurred as a result of the violation and in connection with obtaining a rescission of the loan, including a reasonable attorneys' fee. As drafted, rescission (along with recovery of the actual costs) was the only remedy that could be asserted against assignees and securitizers.

In either case, the creditor and the assignee could avoid rescission as a remedy if, not later than 90 days after the receipt of notification from the consumer of an ATR violation, the creditor or assignee provided a cure. H.R. 1728 defined the term ''cure'' to mean, with respect to a residential mortgage loan that violates the ATR requirements, the modification or refinancing, at no cost to the consumer, of the loan to provide terms that would have satisfied the requirements of ATR if the loan had contained such terms as of the origination of the loan and the payment of such additional costs as the obligor may have incurred as a result of the violation and in connection with obtaining a cure of the loan, including a reasonable attorneys' fee.

In addition to insulating assignees from liability for the four types of monetary damages (except for actual damages against an assignee in a defense to foreclosure after the right to rescind expired) and enabling them to avoid the remedy of rescission if they cured the violation within 90 days of notice, H.R. 3915 went even further to protect innocent assignees and securitizers from bearing responsibility for creditor violations. Assignees and securitizers could avoid the risk of rescission in the first place if:

- the assignee had a policy against buying residential mortgage loans other than qualified mortgages or qualified safe harbor mortgages;
- the policy was intended to verify seller or assignor compliance with the representations and warranties required as set forth below;
- in accordance with regulations that the Federal banking agencies and the Securities and Exchange Commission would have been required to prescribe jointly, the assignee exercised reasonable due diligence to adhere to such policy in purchasing residential mortgage loans, including through adequate, thorough, and consistently applied sampling procedures; and
- the mortgage loan purchase contract from a seller or assignor of the loan contained representations and warranties that the seller or assignor:
  - o was not selling or assigning any residential mortgage loan that is not a qualified mortgage or a qualified safe harbor mortgage; or
  - o was a beneficiary of a representation and warranty from a previous seller or assignor to that effect; and
  - o the assignee or securitizer in good faith took reasonable steps to obtain the benefit of such representation or warranty.

As should be evident, the capital markets strongly resisted wide-ranging assignee liability in H.R. 3915. The distinct treatment of securitizers was one product of that resistance. The term ''securitizer'' meant the person that transfers, or causes the transfer of, residential mortgage loans, including through a special purpose vehicle, to any ''securitization vehicle.'' It excluded a trustee holding such loans solely for the benefit of the ''securitization vehicle.'' In turn, H.R. 3915 defined a ''securitization vehicle'' to be a trust or other legal entity or structure that—

> ''(A) is the issuer, or is created by the issuer, of mortgage pass-through certificates, participation certificates, mortgage-backed securities, or other similar securities backed by a pool of assets that includes residential mortgage loans; and

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(B) holds such loans.''

The Bill differentiated between securitizers and securitization vehicles for purposes of assignee liability. It provided that the terms ''assignee'' and ''securitizer'' did not include the securitization vehicle, the pools of such loans or any original or subsequent purchaser of any interest in the securitization vehicle or any instrument representing a direct or indirect interest in such pool.

H.R. 3915 died when the 110th Congress ended without Senate action, but the spirit of certain of its provisions lived for another day. The 111th Congress revived the concept of ATR in H.R. 1728, with the same name as H.R. 3915. H.R. 1728 ultimately morphed into H.R. 4173, which was the House version of the DFA. Of course, the final provisions of DFA eliminated, among other provisions, the net tangible benefit test, rescission as a remedy, the explicit cure provision, and the limitations on liability for creditors and assignees and securitizers that both H.R. 3015 and H.R. 1728 had adopted.

Comments in Response to the CFPB RFI

Common, but not surprising, themes emerged in the many substantial comments to the CFPB in response to its 2017 RFI. All of the major financial service trade associations commented, as did many of the consumer groups. Below is a summary of oft-repeated requests, of which some are inconsistent with one another:

- Make ATR inapplicable or define QM to include loans originated to be held for investment and in fact held in portfolio for a specified period of time, regardless of type or size or originator;
- Make the ''patch,'' which expires in less than 3 years, permanent and expand the patch to jumbo loans for loans that, but for loan size, would be eligible for delivery to the GSEs;
- Expand the non-conforming, conventional loan exemption, both to increase (or eliminate) the maximum DTI ratio and to replace underwriting in accordance with Appendix Q with underwriting substantially in accordance with current GSE, FHLB, FHA, or VA guidelines and without regard to loan size;
- Clarify what is required for self-employed borrowers and income attribution loans;
- Permit the use of underwriting in conformity with private data models meeting articulated standards of reliability and scientific validity;
- Permit the prudential banking regulators to establish the underwriting criteria for QM loans that qualify for credit under the Community Reinvestment Act;
- Permit the use of predictive technology, such as income estimation models for verification purposes;
- Eliminate the points and fees test or at least further narrow the definition of what constitutes a point or fee, and raise the amount for small dollar loans;
- Raise the regulatory pricing cap for higher cost loans; and
- Permit cures of document deficiencies, DTA calculations, and points and fees.

There is an interesting dichotomy at play. On the one hand, many lenders and secondary market buyers and financiers of mortgage loans, particularly those that have been burned in past government enforcement actions, want to stay within the lines of QM lending. They hope to revise and clarify the rules to achieve this objective. Others covet the enhanced spreads on Non-QM loans, which price the risks of uncertainty, lesser liquidity, and larger legal questions, and believe that these enhanced spreads more than make up for the very occasional foreclosure process that is delayed due to non-QM defenses to enforcement being available to the defaulting borrower.

Conclusion

It is not likely that Congress will repeal the ATR rules, even with a Republican-controlled Congress and Republican President, and even bi-partisan fixes are hard to achieve. It is very possible that the CFPB will seek to amend the QM definitions in light of the many responses to the 2017 RFI. It also is possible, but less likely, that Fannie and Freddie Mac will expand their credit boxes, which will result in more loans falling within the patch. Unless and until that happens—indeed, even if it does happen—we expect that more and more players in the residential finance industry will look to Non-QM loans as a means to increase loan production.

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