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Legal Update

Revising the Regulatory Definition of a Qualified Mortgage

When the federal Consumer Financial Protection Bureau ("CFPB") last summer issued its Advance Notice of Proposed Rule Making ("ANPR") to revise the definition of a "Qualified Mortgage" ("QM") under the Dodd-Frank Act's "ability to repay requirements," all of the single-family housing finance advocates went into high gear. Particularly concerning was the CFPB's announcement that it did not intend to renew the so-called "GSE Patch," which by its terms expires on January 1, 2021, and provides a "safe harbor" compliance presumption for loans eligible for sale to Fannie Mae and Freddie Mac. Should there be a replacement, the CFPB asked, and, if so, what should it be?

The questions posed by the CFPB in the ANPR essentially reiterate the continuing policy debate of whether underwriting standards *should*:

- be required at all for a Qualified Mortgage if the other elements of the definition are satisfied; and
- if so:
    - be limited to higher priced loans that may present a greater risk of consumer vulnerability or default risk; or
    - consist of prescribed standards that are substantially similar to existing requirements or those that modify, supplement or replace the existing standards; and
- provide a conclusive or rebuttable presumption of compliance.

CFPB Director Kraninger gave a preview of what to expect from the CFPB when she testified earlier this month before the House Financial Services Committee. She announced that the CFPB is trying hard to issue a proposed rule by May of this year, which will reflect the CFPB's decision to eliminate a Debt-to-Income ("D-T-I") threshold for QMs and instead include an alternative, such as a pricing threshold. This means that the revised rule would eliminate the alternative underwriting standard that presently exists in the regulatory definition of QM-namely, a limit of a 43% D-T-I calculated in accordance with the CFPB-promulgated Appendix Q. She also announced the CFPB's expectation to propose to extend the expiration of the GSE Patch for a short period until the earlier of the effective date of the proposed alternative or until one or more of the GSEs exits conservatorship.

This announcement of what to expect in a proposed rule on the ability to repay ("ATR") requirements by no means ends the debate on the future regulatory definition of QM, particularly giving the timing of the rule making process in the context of a Presidential election in November. While there are a lot of open issues, two key issues generating significant debate are whether: (i) the price of a loan is the proper measure of borrower risk of default or the need for greater protection and (ii) the revised regulation should include an explicit underwriting standard to replace the GSE Patch and the 43% D-T-I test?

Two Key Open Issues

Is price the proper measure of borrower risk of default or need for extra protection?

Director Kraninger has testified that the CFPB's proposed rule likely will rely on price of the loan to determine eligibility for QM status. By price, she means a spread between the loan's "annual percentage rate" ("APR") and the "average prime offer rate" for a comparable transaction ("APOR"), which is based on average interest rates, fees, and other terms on mortgages offered to highly qualified borrowers. This price test presently is used in the ATR regulations to determine whether an otherwise eligible QM loan morphs from a safe harbor or conclusive presumption of compliance to one that has a more limited rebuttable presumption of compliance where insufficiency of residual income is the only way to rebut the presumption.

The price of a loan to a consumer often is used as a proxy for the need for greater governmental intervention. State usury laws are the best example, where a violation can cause a loan to be void or voidable, although federal preemption limits the applicability of these laws in the case of first-lien residential mortgage loans. High cost loans under the Home Ownership Equity Protection Act or HOEPA also are subject to greater restrictions and potential liability; indeed, the applicability of the ability to repay concept originated with HOEPA for residential mortgage loans with interest rates or total points and fees in excess of a statutory trigger, and state mini-HOEPA laws reduced the financial triggers to capture more loans. Moreover, limiting the ability to repay requirements to loans above a price threshold was the original construct of the existing federal ability to repay law based on the 2007 House-passed HR-3915, Mortgage Reform and Anti-Predatory Lending Act, as well as the separate 2008 Federal Reserve Board's regulations. Thirteen years later, the CFPB presently plans to return to its original roots—a creditor's requirement to make a reasonable determination of a borrower's ability to repay.

But what is it about the price of a loan that makes it an effective dividing line between the need for regulation and either no regulation or less regulation? One thought is that the "A" market works quite well and doesn't need any more government intervention. Of course, the "ALT-A" market and its reliance on no documentation or limited documentation loans was anything but a paragon of perfection, but the CFPB has not indicated an intention to eliminate or dilute the statutory and regulatory QM's requirement to document income and other assets. Did the pure "A," full documentation market suffer from the types of origination abuses that contributed to the financial crisis? Most probably would say no, except perhaps with respect to non-traditional product types like option payment ARMs. Another rationale is that borrowers who obtain higher priced loans evidence either an inability or lesser ability to comparison shop for credit or whose poor credit histories make them a potential target for abusive lending practices and thus need greater protection.

Is price an effective proxy for the need for greater governmental regulation? For example, does price serve as an accurate predictor of a greater likelihood of borrower default? The September 19 comment letter to the CFPB by the Urban Institute says yes, that price is a better predictor of default than D-T-I. Yet one observation in the non-QM market these days is that yields are coming down in relation to the lesser availability of loans to be sold and the higher availability of potential purchasers. This decline in yield does not reflect a decline in the borrower's risk of default but instead is the result of basic market forces. Perhaps APOR already accounts for these market forced based on how it is calculated, but it is a conventional index that might not take into account secondary market pricing distortions for other types of loans; this makes the size of the specified spread over APOR all the more important when using it as a guidepost for borrower default, especially as proponents of the APOR approach suggest borrower default is an appropriate proxy for a borrower's ability to repay.

Also, one thing we have learned from HOEPA and mini-HOEPA laws is that originators often price loans simply to stay right below the financial triggers, again suggesting that there is not necessarily a one-to-one relationship between risk of borrower default and price. Last, originators and investors look to other metrics such as loan-to-value ratios as an important way to manage risk of default and potential severity of loss; LTV ratios do not directly go to a borrower's ability to repay, but do reflect at some level a borrower's willingness to repay. Price certainly is one way to measure perception of the risk of a borrower default, but is it an effective line drawing exercise for the definition of a QM?

If the CFPB were to replace a 43% D-T-I test with a spread over APOR price test, the remaining requirements for a QM loan likely would remain. For example, while the CFPB has broad statutory delegation of authority to revise the QM criteria, the statutory requirements include (i) a 3% limit on total points and fees, (ii) a ban for QM purposes on non-traditional loan products and features and (iii) a requirement to document income and other financial resources (but without the guidance of Appendix Q unless a replacement is proposed). In other words, eligibility for QM status would not depend on price alone.

Should there be an underwriting standard to replace the GSE Patch and a 43% DTI?

Did you know that the statutory language of the Dodd-Frank Act does not require an underwriting standard in its definition of a QM? It authorizes but does not require the CFPB to include an underwriting requirement, such as a D-T-I ratio. Nor does the statute speak in terms of a "safe harbor" or conclusive presumption, on the one hand, and a rebuttable presumption, on the other. Rather, it states that a QM loan is presumed to comply with the ability to repay requirements.

The CFPB used its broad delegation of authority to create the GSE Patch and the 43% D-T-I ratio as defined by Appendix Q as alternative underwriting elements for the regulatory definition of QM, as well as to bifurcate the concept of a presumption into a conclusive presumption and a rebuttable one. What the CFPB gives it has authority to take away, and that's just what the CFPB presently intends to do. So what would the construct look like without the GSE Patch or the 43% D-T-I alternative requirements?

Well, the three statutory elements identified above would still be required for a QM loan, and the question is whether that is enough. Many believe it is, particularly if price is overlaid as an element in lieu of an explicit underwriting standard. One capital markets veteran explained it to me as follows: the layering of risk was the real problem that led

to the calamity in the residential lending market; if you require lenders to document income and restrict more risky loan product types, the likelihood of a repeat of what happened before is materially less. Why? Because lenders and investors are not likely to disregard information in the loan files that should alert them to the borrower's potential inability to repay the loan. Imagine the disclosure in an offering memorandum for a private label securitization to the effect that the originator's underwriting guidelines did not require the lender to take into account the documented income evidenced in the loan file. Not all want to rely on that approach, however. And, in any event, there remains uncertainty on how to satisfy the documentation standard; most believe that Appendix Q was not a good enough reference point, but, without it, what's the applicable standard?

Three short terms alternatives to silence on underwriting are circulating among various stakeholders. One idea is to replace the existing 43% D-T-I standard with a more flexible one, enabling the 43% test to increase on a sliding scale to 50% based on the presence of various compensating factors. This approach has a lot of appeal for those who want a prescriptive and relatively objective standard, with a dose of flexibility. It has less appeal to those who think that D-T-I is an ineffective way to determine the risk of a borrower's default and would result in otherwise eligible borrowers losing out on credit. Another idea is to set a minimum "floor" as a baseline, but letting lenders experiment with other underwriting standards that they think are suitable. Of course, there are as many opinions as there are potential options on what the "floor" should look like.

And the last option calls for importing the "consider" element from the base ATR requirements to consider the eight enumerated underwriting factors into the definition of a QM but not define how one must consider these elements. The approach would not be to seek to define "how" a lender must consider those eight underwriting factors but instead rely on evidence in the loan file to demonstrate that in fact the lender considered such factors based on its own underwriting guidelines. The "whether" instead of "how" approach is predicated on the assumption that neither a regulator nor a consumer could second guess the sufficiency or wisdom of the lender's particular underwriting guidelines but only whether the lender did what it said it would do in considering the enumerated factors. This approach is particularly appealing for the conforming conventional and government-insured or -guaranteed market in that the respective agencies' underwriting guidelines likely would have a disciplining effect on lenders without giving the agencies an explicit comparative advantage to achieve QM status. But it also assumes that the "whether" versus "how" distinction holds up in litigation or an enforcement proceeding.

There also are industry proposals to establish a "self-regulatory organization" ("SRO") to propose QM standards for documenting income and underwriting and that perhaps could obtain CFPB sign-off assuming the standard setting process accounts for the views of a wide swath of stakeholders. While such an approach is particularly intriguing, it presents many important issues to be considered and resolved. It may, however, provide an attractive alternative to the broad gap between no articulated standards and fixed standards that could be out-of-date soon after their adoption. If such an approach could dynamically adjust to technological and market changes on a relatively real time basis and with the imprimatur of the CFPB, it may just provide the flexibility that most sides would prefer without creating the legal uncertainty of undefined standards. The

question, of course, is how long might it take to establish and operationalize a SRO and what happens in the meantime?

In evaluating alternatives to the existing regulatory construct of a QM loan, it is important to think about what QM status really means. Basically, a QM loan is insulated from scrutiny as to whether the lender satisfied the ATR requirements. Either the government or a private plaintiff could challenge if a loan as a matter of fact is a QM loan, but, if so, the question of compliance with ATR is definitively answered. This assumes that the presumption of compliance is defined as a conclusive presumption or safe harbor, but it appears the CFPB is going in that direction.

The more subjective the test is for QM status, the less meaningful the distinction is between a QM loan or a non-QM loan. Think about it. Eligibility of a loan for sale to Fannie Mae or Freddie Mac can be objectively verified through an "accept" designation from their respective automated underwriting systems. A 43% or higher D-T-I ratio is an objective test, but one always can challenge the proper calculation of income; if compensating factors are added in, the objectivity of the test could be more complicated based on the composition of such factors and the prescribed manner in which they are used. And in a paradigm where a lender is required to consider or take into account enumerated underwriting factors, the question of "how" the lender considered such factors can dilute the value of a potential QM status. If the lender has to prove that it properly evaluated the eight underwriting factors in order to be relieved of the obligation to consider such factors, what good is the QM status when caught up in litigation or an enforcement proceeding over what proper evaluation means?

There are two other important issues that should inform the decision of whether and, if so, how to include an underwriting element in the revised regulatory definition of a QM loan. The first is assignee liability. While money is pouring into purchases of non-QM loans these days, I am told there is considerably less money than otherwise might be available because of the risk of assignee liability. Remember that a subsequent holder of a non-QM loan is subject to the risk of a borrower defense or counterclaim to the enforcement of a loan in foreclosure based on a creditor's violation of ATR. The loan does not become ineligible for foreclosure but the borrower who can prove a violation is entitled to monetary damages that serves as an offset to the outstanding indebtedness. Since the law does not explicitly prescribe how a lender must consider the enumerated underwriting factors, there always is the risk that a borrower may challenge the sufficiency of the consideration; and it is the subsequent holder that bears the credit risk of loss without an ability to conduct advance due diligence to determine if the applicable underwriting guidelines definitively comply with ATR. Investors who are particularly concerned about assignee liability likely would prefer more specificity around an underwriting guideline if one were to be required in the revised definition of QM.

The risk retention rules for private securitization is the second important issue to consider. By statute, "qualified residential mortgages" ("QRM") are exempt from the risk retention rules enacted in the Dodd-Frank Act. The implementing regulations incorporate the definition of a QM loan into the definition of a QRM loan—they are one and the same.

While the statute provides that a QRM loan cannot be defined in a way that is broader than the definition of a QM loan, it does not require that the terms be defined in the same way. The agencies that promulgated the risk

retention rules (i.e., SEC, OCC, FRB, FDIC, FHFA and HUD) will have a decision to make if and when the definition of a QM is revised by the CFPB. Do they go along for the ride or seek a different path? They already have issued a "request for information" to try to get ahead of the ultimate choice they will have to make. But the ATR and risk retention provisions of the Dodd-Frank Act don't exactly overlap in their public purposes, so it would be interesting to see whether a world in which QM is not subject to an explicit underwriting requirement also is one in which the risk retention rules would not apply to those loans in non-conforming conventional securitizations.

Conclusion

It took almost two years for the CFPB to develop the final ATR rules, including the regulatory definition of a QM. This timing in part was due to the relative infancy of the new agency but also reflected a variety of strongly held views on how to balance the competing public policy interests of facilitating access to responsible credit and seeking to limit the making and sale of residential mortgage loans that borrowers simply couldn't afford. Many of those same stakeholders are involved this time around in the debate with a hope that a compromise consensus will emerge, and a self-regulatory organization may be the way to break the logjam. Whether that will happen at all or within the time frame for this administration conclusively to act is anybody's guess.

For more information about the topics raised in this Legal Update, please contact the author, partner Laurence E. Platt.

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