

CFPB Releases Final Mortgage Rules: Ability-to-Repay and Qualified Mortgage Rule Sets New Mortgage Underwriting Standards

On Thursday, January 10, 2013, the Consumer Financial Protection Bureau (“CFPB”) issued three final rules setting out significant new standards for mortgage underwriting and escrow requirements and a concurrent request for comment on whether the final rules should be adjusted for certain lending programs. The final rules address: (1) the long-awaited standards on “Ability-to-Repay” and “qualified mortgages” (“QM Rule”);¹ (2) the expanded scope of the Home Ownership and Equity Protection Act (“HOEPA”);² and (3) the escrow account requirements for “higher priced mortgage loans” under the Truth in Lending Act (Regulation Z).³ The QM Rule and HOEPA rule are effective on January 14, 2014, while the Reg Z escrow rule is effective on June 1, 2013. Each of these rules implements key consumer protection provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”).

The QM Rule includes the following key components:

- (a) an ability-to-repay standard that requires lenders to obtain and verify information supporting the borrower’s ability to make the periodic payments for mortgage loans;
- (b) a definition of “qualified mortgage” (“QM”) that uses product feature, underwriting and document standards, including a debt-to-income ratio;

¹ Ability-to-Repay and Qualified Mortgage Standards under the Truth in Lending Act (Regulation Z) (Jan. 10, 2013) (to be codified at 12 C.F.R. pt. 1026) available at http://files.consumerfinance.gov/f/201301_cfpb_final-rule_ability-to-repay.pdf.

² High-Cost Mortgage and Homeownership Counseling Amendments to the Truth in Lending Act (Regulation Z) and Homeownership Counseling Amendments to the Real Estate Settlement Procedures Act (Regulation X) (Jan. 10, 2013) (to be codified at 12 C.F.R. pts. 1024 and 1026) available at http://files.consumerfinance.gov/f/201301_cfpb_final-rule_high-cost-mortgages.pdf.

³ Escrow Requirements Under the Truth in Lending Act (Regulation Z), 78 Fed. Reg. 4726 (Jan. 22, 2013) (to be codified at 12 C.F.R. pt. 1026) available at http://files.consumerfinance.gov/f/201301_cfpb_final-rule_escrow-requirements-amendments.pdf.

(c) a two-tier safe harbor standard that provides a complete safe harbor for compliance with the ability-to-repay requirement for ‘prime’ loans and rebuttable presumption protection for ‘higher-priced’ mortgage loans;

(d) a limited exemption to allow balloon-payment loans to qualify as QMs for small lenders operating predominately in rural or underserved areas; and

(e) exceptions to the normal QM standards for up to seven years for specific lending programs, such as non-profit programs for low to moderate income consumers, housing finance agency programs, and homeownership stabilization programs such as the Making Home Affordable program, and for mortgages purchased, guaranteed or insured by the Government Sponsored Enterprises (“GSEs”), while in conservatorship, and for certain other federal programs. These special rules will sunset no later than January 10, 2021.

The CFPB sought additional comment on whether the new standards should be modified to address potential adverse consequences on certain of the last-noted categories of lending programs.⁴

Background

The Dodd-Frank Act imposes new requirements for mortgage lending that generally require lenders to show that they verified the borrower’s ability to repay the mortgage and that provide for potential safe harbors for mortgages meeting QM standards.⁵ The Act also sets consequences for failing to meet the ability-to-repay requirements. Section 1416 of the Dodd-Frank Act amends the Truth in Lending Act to provide that borrowers who bring actions within three years of the occurrence of a violation of the ability-to-pay requirements would be entitled to special statutory damages from the lender equal to the sum of all financing charges and fees, unless the lender could show that the violations were not material.⁶ Additionally, pursuant to section 1413 of the Dodd-Frank Act, a consumer may assert a violation of the ability to pay requirement in a foreclosure proceeding (including against an assignee of the lender) “as a matter of defense by recoupment or setoff,” and this defense is not time limited.⁷ The QM Rule sets the QM standards and the areas of risk for lenders under the Truth in Lending Act.

⁴ Proposed Amendments to the Ability to Repay Standards under the Truth in Lending Act (Regulation Z) (Jan. 10, 2013) available at http://files.consumerfinance.gov/f/201301_cfpb_concurrent-proposal_ability-to-repay.pdf.

⁵ Dodd-Frank Act §§ 1411 and 1412, Truth in Lending Act § 129C, 15 U.S.C. § 1639(c).

⁶ Truth in Lending Act § 130(a), 15 U.S.C. § 1640(a).

⁷ Truth in Lending Act § 130(k), 15 U.S.C. § 1640(k).

As a result, the QM Rule is particularly significant because, in effect, it sets the minimum underwriting standards for the mortgages that will be broadly available in the U.S. market. It addresses some of the significant underlying causes of the mortgage crisis that began to unfold in 2007 and led to the financial crisis. First, the QM Rule effectively bars so-called ‘stated-income loans’ by requiring mortgage lenders to obtain and verify the critical information necessary to underwrite mortgages. Second, the QM Rule makes it much less likely that lenders will offer certain mortgages in significant quantities, such as negative amortizing loans and balloon payment loans, by implementing the Dodd-Frank provisions that deny lenders of such mortgages a safe harbor from or rebuttable presumption against challenges to their compliance with the ability-to-repay requirements. While the rule implements limited exceptions to these standards – including one for balloon payment loans made by small lenders serving rural or underserved areas – the greater likelihood of challenges to loans that do not meet the QM standard means that non-QM loans are much less likely to be made or attain the volume necessary to create a secondary market. While this inherently decreases mortgage market liquidity, the rule is aimed at limiting the potential for a return of widespread aggressive mortgage lending based on the mortgage structures – such as negatively amortizing loans and 2-28 and 3-27 loans with structural “payment shock” – that defaulted at historic rates during the recent mortgage crisis.

These standards also are a further development in redefining mortgage finance and the housing market in the United States. The underwriting standards represented by the QM Rule and the HOEPA rule, along with the servicing standards released by the CFPB on January 17, 2013,⁸ have begun to create a different model for mortgage finance than that prevailing prior to the crisis. These standards, and their attendant more restrictive underwriting and compliance requirements, certainly should make mortgage lending less risky to lenders and consumers. However, they will also make mortgages more expensive and less available to some borrowers.

An essential part of the long-standing favorable interest rates and liquidity of the American mortgage finance system has been a deep and robust secondary market. GSEs have long played a vital role, but the private secondary market also played an important part in that market for many years until the financial crisis. However, while securitization for other asset classes has rebounded, mortgage securitization remains largely moribund. As a result, the mortgage finance system is dominated by the GSEs to an unprecedented extent. There are many reasons for this, but the uncertainty and funding issues surrounding an asset class that was a major contributor to the tremendous losses underlying the financial crisis probably hold a central place.⁹

⁸ Mortgage Servicing Rules under the Real Estate Settlement Procedures Act (Regulation X) (Jan. 17, 2013) (to be codified at 12 C.F.R. pt. 1024) available at http://files.consumerfinance.gov/f/201301_cfpb_final-rule_servicing-respa.pdf.

⁹ See Remarks by Thomas J. Curry, Comptroller of the Currency, before the American Securitization Forum, Las Vegas, Nevada, January 28, 2013, available at <http://occ.gov/news-issuances/speeches/2013/pub-speech-2013-19.pdf>.

Structurally, there are several elements that remain to be defined before the future of American mortgage finance can be discerned with any clarity. These elements must start with the future of the government role in mortgage finance both in providing a secondary market and in facilitating lending to some borrowers, such as low and moderate income borrowers. Whether the housing GSEs, such as Freddie Mac and Fannie Mae, will continue to exist, and in what form and for what roles, along with the future roles of Ginnie Mae and the Federal Housing Administration among others, will have an enormous impact on American mortgage finance.

A second major component of the future of mortgages in America is the future shape of the private secondary market. This, of course, is inextricably tied to the future role of the GSEs since any reform of the GSEs must be based on the form and scope of the private secondary market. The linchpin for the private secondary markets remains the future government role in mortgage finance. Until that is resolved, private sector development of a secondary market is likely to lag. This future private secondary market is likely to consist of some combination of securitization and mortgage-backed covered bonds, which have been a core part of the European mortgage market for many years but still await final legislation in the United States. While covered bonds cannot replace the volume of mortgages previously securitized, the potential of covered bonds as an alternative financing mechanism for mortgages will influence the diversity and depth of the private secondary markets.

The new QM rule does provide the foundation for another key element in mortgage finance – the standards that will be applied for risk retention. Section 941(b) of the Dodd-Frank Act generally requires the Federal Reserve, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency and the Securities and Exchange Commission, and, for “residential mortgage assets,” the Department of Housing and Urban Development and the Federal Housing Finance Agency, to prescribe regulations that require a securitizer of asset-backed securities to retain at least five percent of the credit risk of the assets underlying the securities.¹⁰ The statute also provides that mortgages that meet a regulator-defined standard as “qualified residential mortgages” (“QRMs”) are exempt from the risk retention requirement. The new CFPB QM Rule helps set the standard for QRMs because section 941(b) requires that the term “QRM” be defined to be no broader than the definition of “qualified mortgage.”

When the proposed risk retention standards were released on March 31, 2011,¹¹ banks, consumer groups, legislators, and many others were very critical of the proposals because they included a QRM standard requiring a 20 percent down-payment and imposing other strict underwriting standards, such as credit history requirements and a total debt-to-

¹⁰ Securities Exchange Act § 15G, 15 U.S.C. § 78o-11.

¹¹ Credit Risk Retention, 76 Fed. Reg. 24090 (Apr. 29, 2011).

income ratio not to exceed 36 percent (the QM Rule, as explained below, has a higher limit of 43%). Many critics argued that the strict standards would deny many low and moderate income borrowers access to affordable mortgages.

While the precise shape of any final risk retention and QRM standards remains to be defined, the QM Rule sets the parameters for a final QRM standard. Now that the CFPB has defined QMs to include a debt-to-income ratio as well as other lending standards, the QM Rule addresses many of the key requirements for sound underwriting. This may place pressure on the regulators responsible for the risk retention standards to set a QRM standard that effectively mirrors the CFPB QM standard.

While the QM Rule applies broadly to all mortgages and the QRM rule applies only to securitized mortgages, the two standards are clearly linked, and not only because the QRM standard cannot be “broader” than the QM standard. Now that the QM Rule has defined a minimum standard with a safe harbor, it is likely that far fewer loans will be made that fall below that minimum. Because a vibrant securitization market requires sufficient volume to provide liquidity for the resulting securities, if the QRM standard is set with higher debt-to-income ratios than the QM standard and with a 20 percent down payment requirement, there may be insufficient liquidity for a vibrant QRM securitization market. On the other hand, a bifurcation of the QRM and non-QRM mortgage market may mean that neither group of mortgages produce sufficient liquidity. At best, the latter scenario would likely create a mortgage market where non-QRMs would be held exclusively on balance sheet and would be much more expensive due to their limited liquidity. In this way, the CFPB QM Rule may determine the future of the risk retention rule for mortgages and could mean that the final QRM standard will be virtually the same as the QM standard.

For all of these reasons, the CFPB’s new QM Rule is a significant step towards defining the future of American mortgages.

The Final QM Rule

The following section provides a high-level summary of the key components of the QM Rule:

I. Key Provisions

1. Scope of final rule: The final rule applies to consumer credit transactions secured by a dwelling (including real property attached to the dwelling), other than home equity lines of credit, mortgages secured by timeshare plan interests, reverse mortgages, or temporary or bridge loans with terms of 12 months or less.
2. Ability-to-repay requirement: A residential mortgage lender is generally prohibited from making mortgage loans unless it has made a reasonable and good faith

determination at or before consummation that the borrower has a reasonable ability to repay. This determination must take into account the borrower's (i) income and assets, (ii) current employment status, (iii) monthly payments on the loan, (iv) monthly payments on any simultaneous loans, (v) monthly payments for mortgage-related obligations (*e.g.*, insurance, tax), (vi) other debt obligations, alimony and child support, (vii) monthly debt-to-income ratio or residual income and (viii) credit history.

- a. Lenders must generally evaluate the factors using information verified from reasonably reliable third-party records.
- b. The final rule does not impose a particular underwriting model – it only requires that these factors be taken into account in underwriting mortgages. However, it does provide some detailed guidance as to the calculations involved. For example, payment calculations generally are to be made at the greater of the fully indexed rate or introductory rate and by assuming monthly, fully-amortizing payments that are substantially equal, though there are special rules for loans with balloon payments, interest-only payments, or negative amortization.
- c. Exemption from ability-to-repay requirement for certain refinancings: In order to address some of the continuing challenges of borrowers who now have loans that do not meet the QM standards – such as negative amortization loans or interest only loans – the final rule provides an exemption from the ability-to-repay requirements for refinancings of “non-standard mortgages” into “standard mortgages.”
 - i. Under the final rule, standard mortgages must have: terms of less than 40 years, a fixed interest rate for at least five years after consummation, points and fees that are capped generally at 3% (excepting certain bona fide points) and proceeds that are only used to pay off the outstanding principal balances of the non-standard mortgages and certain closing or settlement charges. They also must have periodic payments that do not result in: an increase to the principal balance, deferral of principal repayments, or balloon payments. The lenders of standard mortgages must be the current holders of the non-standard mortgage or servicers acting on their behalf, and monthly payments under the standard mortgage must be materially lower. Borrowers must have no more than one payment that is 30-days delinquent in the 12 months before applying for the standard loan (and none in the 6 months before applying) and must apply for the standard mortgage no later than two months after the non-standard mortgage has recast. The lender must consider whether

the standard mortgage will likely prevent the borrower's default on the non-standard mortgage once it has recast.

1. Any non-standard loan consummated after January 10, 2014 will not be eligible for the exemption described above (*i.e.*, refinancing into a standard mortgage without requiring a new ability-to-repay determination at the time of refinancing), unless the non-standard loan itself had complied with the ability-to-repay requirements.
 - ii. The CFPB has, in a concurrent proposed rule, sought comment on whether to also exempt designated non-profit lenders, homeownership stabilization programs and certain federal agency and GSE refinancing programs from the ability-to-repay requirements, as these are already subject to separate underwriting criteria.¹²
3. QMs and the Presumption of Compliance:
- a. The Dodd-Frank Act grants a residential mortgage lender (or assignee) a presumption that it has met the ability-to-repay requirements for "qualified mortgages."¹³ The statute generally excludes from the definition of QM all loans with negative amortization, interest-only payments, balloon payments, terms exceeding 30 years, or points and fees that total more than 3% of the total loan amount. In addition, the statutory definition requires lenders to (1) verify and document the borrower's income and resources relied upon to qualify for the loan and (2) underwrite the loan based on a fully amortizing payment schedule and the maximum interest rate in the first five years. The Act vests discretion in the CFPB to decide whether additional or revised requirements should apply for QMs and whether the presumption is conclusive (*i.e.*, a safe harbor) or rebuttable. The final rule implements the statutory criteria and establishes additional underwriting criteria.
 - b. "Qualified Mortgage" generally defined under the final rule: The final rule defines "qualified mortgages" to have the following general characteristics:
 - i. Product features:
 1. Excludes loans with negative amortization, interest-only payments, balloon payments.

¹² Proposed Amendments to the Ability to Repay Standards under the Truth in Lending Act (Regulation Z) (Jan. 10, 2013) available at http://files.consumerfinance.gov/f/201301_cfpb_concurrent-proposal_ability-to-repay.pdf.

¹³ Dodd-Frank Act § 1412.

2. Terms cannot exceed 30 years.
 3. Points and fees cannot exceed certain thresholds. For mortgages above \$100,000, points and fees allowed for QMs are capped at 3%.
 - a. Notably, points and fees exclude bona fide third-party charges and certain reasonable fees (such as appraisal fees and inspection fees) but not if they are retained by the lender, loan originator or an affiliate of either.
 - b. Points and fees include all compensation paid directly or indirectly to a loan originator or lender by the borrower that can be attributed to the transaction at the time the interest rate is set.
 - c. Points and fees include the maximum prepayment penalty that may be charged or collected under the terms of the mortgage loan and the total prepayment penalty if the borrower refinances.
- ii. Underwriting requirements:
1. The borrower's income, assets, debt obligations, alimony and child support must be verified (*i.e.*, no "no-doc" loans). The final rule provides detailed guidance as to the calculation of these.
 2. The loan must be underwritten based on a fully amortizing payment schedule and the maximum interest rate during the first five years.
 3. The borrower's debt-to-income ratio cannot exceed 43% at the time of consummation of the mortgage. Debt includes both payments on the mortgage as well as certain recurring obligations such as child support, alimony, monthly household expenses and revolving accounts. Together with the verification required under (1), the calculation of the debt-to-income ratio incorporates most of the general ability-to-repay underwriting requirements into the definition of QM, including verification of employment status and monthly payments on the covered transaction and on any simultaneous loan known to the lender.

4. There are no loan-to-value or minimum down payment requirements for QMs, unlike the March 2011 proposal (by the federal banking regulators and other agencies) for QRMs.
- c. Safe harbor for non-higher-priced QMs: The final rule provides the stronger shield of a safe harbor against ability-to-pay litigation for QMs that are not higher-priced mortgages.
 - i. Higher-priced mortgages are defined as those having annual percentage rates that exceed the average prime offer rate for comparable transactions by more than 1.5% for first-lien mortgages, and by 3.5% or more for subordinate-lien mortgages. Higher-priced mortgages correspond to what is commonly described as sub-prime mortgages.
 - ii. Defining such mortgages by a fixed basis point spread does have the effect of making the scope of the safe harbor vary under different interest rate markets environments. For example, as market interest rates rise there typically is greater variability in the interest rates of different borrowers. As a result, the narrowing of the relative variability of interest rates around the 'best' available rate at higher interest rates could impact liquidity by constraining natural variations around that higher 'best' rate so that lenders can have the assurance provided by the safe harbor. Conversely, more loans presumably will fall within the safe harbor as interest rates decrease.
 - d. Rebuttable presumption for higher-priced mortgages: Higher-priced mortgages that are QMs are entitled to the weaker shield of a rebuttable presumption that they comply with the ability-to-pay requirements. To rebut the presumption, the borrower must prove that the lender failed to make a reasonable and good faith determination of the consumer's repayment ability at the time of consummation of the mortgage by showing that residual income or assets (after debt obligations, alimony, child support, mortgage-related obligations and monthly payments on the mortgage and any simultaneous loans known to the borrower) would be insufficient to meet living expenses, including any recurring and material non-debt obligations of which the lender was aware at the time of consummation.
 - e. Special categories of QMs: Taking into account the difficult conditions in the current residential mortgage market, the final rule also includes a few temporary categories of QMs that must satisfy the product prerequisites of QMs described above but that can have more flexible underwriting requirements, as long as such mortgages would be eligible to be (1)

guaranteed by the GSEs while they operate under federal conservatorship or receivership, or (2) insured or guaranteed (as applicable) by the U.S. Department of Housing and Urban Development, Department of Veterans Affairs, or Department of Agriculture or Rural Housing Service (until, in each case, the relevant agency defines a QM pursuant to its authority under the Dodd-Frank Act). Only mortgages consummated before January 10, 2021 will qualify for these special categories.

- i. As noted above, a proposal released concurrently with the QM rule would exempt entirely from the ability-to-repay requirements: (1) certain lenders designated by the U.S. Department of Housing and Urban Development; (2) refinancings eligible to be guaranteed, insured or made pursuant to a program administered by the Federal Housing Administration, U.S. Department of Veterans Affairs, or U.S. Department of Agriculture, but only until the related agency issues ability-to-pay requirements for its refinancings; and, (3) refinancings eligible to be guaranteed or purchased by the GSEs that are part of a targeted refinancing program, but only if the GSEs are under conservatorship, the GSE owns the refinancing, and the refinancing is consummated before January 10, 2021 and replaces a prior obligation consummated before January 10, 2014.
- f. Balloon Payment QMs: Balloon payment loans originated and held by certain small lenders would be eligible to be QMs as long as they have a term of at least five years, a fixed-interest rate and they meet certain basic underwriting standards. Such loans are not subject to the 43% debt-to-equity ratio, nor the detailed underwriting guidelines described in the final rule that are generally applicable to QMs. Qualifying small lenders must hold at least 50% of their first lien mortgages in counties that are rural or underserved as designated from time to time by the CFPB, have less than \$2 billion in assets, and (together with their affiliates), originate no more than 500 first lien mortgages yearly and generally hold the loans for three years to maintain their QM status.
 - i. Concurrently with the final rule, the CFPB has proposed creating a new category of QMs for loans without balloon payments that are originated and held by small lenders, though not necessarily those operating predominantly in rural or underserved areas. The CFPB has also proposed increasing the safe harbor threshold for loans originated and held by such small lenders to 3.5% above the average prime offer rate for comparable transactions for first-lien loans.

4. Restrictions on prepayment penalties: The final rule also prohibits prepayment penalties for residential mortgage loans except for QMs that are not higher-priced and have annual percentage rates that cannot increase after consummation. Prepayment penalties cannot apply after the three-year period following consummation, cannot exceed the 2% of the outstanding loan balance in the first two years after consummation (and 1% in the third year). Lenders offering loans with prepayment penalties must also offer an alternative without a prepayment penalty that has an annual percentage rate that cannot increase after consummation and has the same type of interest rate (i.e., fixed or step-rate) and the same loan term. Such alternative—for which the lender should have a good faith belief that the borrower will qualify—must also have the product features of a QM.
5. Anti-evasion provision for open-ended credit: The requirements of the final rule do not apply to open-ended credit, such as revolving credit facilities. The final rule includes an anti-evasion provision that states that mortgage loans cannot be restructured as open-ended credit to evade the requirements of the final rule.
6. Record keeping requirement: Three years from consummation.

II. Key Implications and Developments Looking Forward

1. The Continuing Impact of Regulatory Uncertainty on Mortgage Lending:

The impact that the points and fees limits and the underwriting requirements for QMs will have on lending is unclear. Other regulators (*e.g.*, Chairman Bernanke in a November 2012 speech¹⁴) have noted that current lending standards may be too tight. While some of the underwriting requirements for QMs are less stringent than might have been expected (*e.g.*, the 43% debt-to-income limit and the absence of a mandatory down payment requirement), other requirements (such as the points and fees requirements and the prepayment penalty restrictions) may prove to be onerous.

The safe harbor does remove some regulatory uncertainty that may have contributed to tightness in the mortgage markets. However, some questions remain. Those questions include whether the rebuttable presumption for the higher-priced mortgages is strong enough (particularly because sufficient residual income is not defined, but can be used as a defense in a foreclosure proceeding). There is also the question whether the greater risks inherent in mortgages subject to the rebuttable presumption for higher-priced mortgages will lead lenders to stop making those mortgages and, to the extent that they do, how much those risks will limit the availability and increase the costs of those mortgages. Additionally, the

¹⁴ See Remarks by Ben S. Bernanke, Chairman of the Board of Governors of the Federal Reserve System, before the Operation HOPE Global Financial Dignity Challenge, Atlanta, Georgia, November 15, 2012, available at <http://www.federalreserve.gov/newsevents/speech/bernanke20121115a.htm>

complexity of the standards for QMs themselves may substantially weaken the effectiveness of the safe harbor. For example, borrowers in foreclosure proceedings could assert that they did not have the ability to pay the mortgage by contesting the calculation of points and fees or the debt-to-income ratio, thus preventing summary judgment rulings on mortgages that lenders (or their assignees) believe are QMs. Lenders also would benefit from further guidance on whether they will have the opportunity to cure any deficiencies in their underwriting at the time of closing. Greater clarity on these points could be provided by further guidance from the CFPB and should have salutary effects on mortgage lending.

The CFPB has since released a number of final rules related to mortgages, including servicing,¹⁵ loan originator compensation,¹⁶ and appraisals for certain higher-risk mortgages (issued jointly with other federal agencies).¹⁷ These implement various Dodd-Frank requirements and require changes to business operations in broad swaths of the mortgage industry. These final rules will all become effective on January 10, 2014.

2. Need for GSE Reform and other mortgage-market developments:

The final rule allows GSE-eligible mortgages that meet the product features (but not necessarily the underwriting requirements) of QMs to count as QMs, as long as the GSE is under government conservatorship. In doing so, the final rule does little to try to reduce the predominance of the GSEs in the current mortgage market, and the safe harbor for GSE-eligible loans may even intensify GSE predominance of the mortgage market, particularly because automated underwriting and compliance systems are already in place to determine GSE-eligibility, while new systems must be developed to determine that the general QM or ability-to-pay requirements are met. The inclusion of GSE-eligible loans as QMs is in recognition of the fragile state of the housing market. The final rule leaves open the need for proposals to reduce the predominance of the GSEs in the housing market and for other developments, such as covered bond legislation, that may contribute towards the revival and loosening of credit in the housing mortgage market.

3. The “Qualified Residential Mortgage” Definition:

As noted in the background discussion above, the QM definition is also a necessary prerequisite to the finalization of the QRM definition. Areas of disjuncture between the QRM and QM requirements will need to be watched closely, as they may create additional

¹⁵ Mortgage Servicing Rules under the Real Estate Settlement Procedures Act (Regulation X) (Jan. 17, 2013) (to be codified at 12 C.F.R. pt. 1024) available at http://files.consumerfinance.gov/f/201301_cfpb_final-rule_servicing-respa.pdf.

¹⁶ Loan Originator Compensation Requirements under the Truth in Lending Act (Regulation Z) (Jan. 20, 2013) available at http://files.consumerfinance.gov/f/201301_cfpb_final-rule_loan-originator-compensation.pdf.

¹⁷ Appraisals for Higher-Priced Mortgage Loans (Jan. 18, 2013) available at http://files.consumerfinance.gov/f/201301_cfpb_final-rule_tila-appraisals.pdf.

compliance burdens. For example, the QM Rule requires calculation of debt-to-income at the time of consummation, whereas the QRM proposed rule only requires calculation to occur no more than 60 days prior to closing.¹⁸ The methodology and criteria for QM and QRM standards need to be, at a minimum, based on the same metrics. If debt-to-income is calculated using a different methodology for QRMs than for QMs (as described in detail in the final rule and the accompanying interpretive guidance), this will create duplicative compliance requirements.

4. Implications of the Federal Reserve's Proposed Capital Rules:

On June 7, 2012, the Federal Reserve proposed a rule that would diverge from the Basel III framework with respect to risk weights for residential mortgages.¹⁹ Under the proposal, loans would be separated into two risk categories based on certain underwriting and product characteristics. Category 1 loans would be subject to much lower risk weights, ranging from 35% to 100% based on the loan-to-value ratio.

QMs meet many of the same conditions, including underwriting standards and product characteristics, that would be required for Category 1 mortgages:

- a. Both cannot have terms exceeding 30 years and must have regular payments.
- b. Subject to some exceptions, both generally cannot have negative amortization payments, allow deferrals of repayments of principal, or have balloon payments.
 - i. Importantly, although balloon payment mortgages made in rural or underserved areas are QMs under the exception, they would not be eligible for a Category 1 risk weighting, which may limit the use of the exception.
- c. Ability to repay determinations should take into account the maximum interest rate that may apply during the first five years.

Nonetheless, QMs do not meet some of the proposed requirements for Category 1 loans. For example, a Category 1 loan, as proposed, must have an interest rate that is not allowed to increase by more than 2% in any 12-month period or by more than 6% over the life of the loan.

¹⁸ Credit Risk Retention, 76 Fed. Reg. 24,090, 24,166 (Apr. 29, 2011).

¹⁹ Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements, 77 Fed. Reg. 52888 (Aug. 30, 2012).

Even if lenders are comfortable with writing non-QMs and not being eligible for the safe harbor or rebuttable presumption of compliance with the ability-to-repay requirement for such loans, as applicable, the risk-based capital rules, if adopted as proposed, would increase pressure to comply with the QM standards.

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