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JANUARY 5, 2021

CFPB Retires the "QM Patch" and Revises QM Rules

by Stephen Ornstein

In a significant final rulemaking with potentially far-reaching consequences for the residential mortgage markets, the Consumer Financial Protection Bureau (CFPB) is terminating the "QM Patch" and significantly revising the criteria for what constitutes a qualified mortgage (QM) loan.

Notably, in this rule issued on December 10, 2020, the CFPB replaces the dreaded Appendix Q and strict 43% debt-to-income (DTI) underwriting threshold with a priced-based QM loan definition. The rule takes effect on February 27, 2021, but compliance with it is not mandatory until July 1, 2021. The QM Patch will expire on the earlier of July 1, 2021 or the date that the government-sponsored enterprises (GSEs) exit conservatorship.

In a separate rulemaking, the CFPB promulgated new rules for "seasoned QM loans."

Background

The CFPB's ability-to-repay/QM regulations, promulgated pursuant to the Dodd–Frank Act, require a creditor to make a reasonable, good-faith determination at or before consummation that a consumer will have a reasonable ability to repay the loan according to its terms. (The obligation applies to a consumer credit transaction secured by a dwelling.)

The regulations currently provide:

- A "safe harbor" for compliance with the ability-to-repay rules to creditors or assignees of loans that satisfy the definition of a QM and are not higher-priced mortgage loans.
- A "rebuttable presumption" of compliance with the ability-to-repay rules to creditors or assignees for higher-priced mortgage loans.

A "higher-priced mortgage loan" has an annual percentage rate (APR) exceeding the average prime offer rate (APOR) by 1.5 or more percentage points for first-lien loans or by 3.5 or more percentage points for subordinate-lien loans.

The QM Patch

In many instances, in order for a loan to achieve QM status, it must be underwritten in accordance with the exacting standards of Appendix Q and the consumer's DTI ratio may not exceed a 43% hard limit. However, the CFPB regulations eliminate these particular requirements if the loan is eligible for purchase by, among others, Fannie Mae and Freddie Mac. Consequently, a loan satisfies the QM Patch if it can be sold to one of the GSEs and meets certain other QM criteria (including that the points do not exceed the 3% threshold and the loan is fully amortizing and doesn't have a term exceeding 30 years).

The QM Patch has significantly enhanced the presence of the GSEs in the QM market since the GSEs are in effect backstopping the underwriting of these loans. This exemption is set to expire upon the earlier of the termination of the conservatorship of the particular GSEs or January 10, 2021.

What the rule did not anticipate is that the conservatorship of the GSEs would continue years after the effective date of the CFPB regulations (January 10, 2014). Many have criticized the QM Patch for giving an undue advantage to the government-subsidized GSEs at the expense of the private residential mortgage market participants and have clamored for its elimination.

The Final Rulemaking: QM Patch Expiration

Notably, under the final rule, the QM Patch permanently sunsets on the earlier of July 1, 2021 or the date the GSEs exit conservatorship. The timing is tricky because Mark Calabria, the director of the Federal Housing Finance Agency, the entity that supervises the conservatorships of Fannie Mae and Freddie Mae, has indicated that he might seek to terminate the conservatorships before President Trump's departure from office. In recent remarks, however, Treasury Secretary Steven Mnuchin has indicated that termination of the conservatorships is not imminent.

Significantly, the expiration of the QM Patch does not affect the QM definitions that apply to Federal Housing Administration (FHA), Department of Veterans Affairs (VA), Department of Agriculture (USDA), or Rural Housing Service loans. In other words, loans eligible to be insured or guaranteed by these agencies may still constitute QMs if they meet the agencies' respective definitions of a QM.

Appendix Q and 43% DTI Requirement Removal

Further, in this final rule, the CFPB eliminates the Appendix Q 43% DTI underwriting requirements and replaces them with a priced-based QM definition.

Under the rule, for first-lien transactions, a loan receives a conclusive presumption that the consumer had the ability to repay (and hence receives the "safe harbor" presumption of QM compliance) if the APR does not exceed the APOR for a comparable transaction by 1.5 percentage points or more as of the date the interest rate is set. A first-lien loan receives a "rebuttable presumption" that the consumer had the ability to repay if the APR exceeds the APOR for a comparable transaction by 1.5 percentage points or more but by less than 2.25 percentage points. The final rule provides for higher thresholds for loans with smaller loan amounts, for subordinate-lien transactions, and for certain manufactured housing loans.

In order to qualify for QM status, the loan must continue to meet the statutory requirements of the 3% points and fees limits, and must not contain negative amortization, a balloon payment (except in the existing limited circumstances), or a term exceeding 30 years.

Consider and Verify Consumer Income and Assets

In lieu of underwriting to Appendix Q, the final rule requires that the creditor *consider* the consumer's current or reasonably expected income or assets other than the value of the dwelling (including any real property attached to the dwelling) that secures the loan, debt obligations, alimony, child support, and DTI ratio or residual income. The final rule also requires the creditor to *verify* the consumer's current or reasonably expected income or assets other than the value of the dwelling (including any real property attached to the dwelling) that secures the loan and the consumer's current debt obligations, alimony, and child support.

Consider Requirement

In particular, in order to comply with the requirement to "consider" under the rule, the CFPB provides creditors the option to consider either the consumer's monthly residual income *or* DTI. The CFPB imposes no bright-line DTI limits or residual income thresholds.

As part of the consider requirement, a creditor must maintain policies and procedures for how it takes into account the underwriting factors enumerated above, as well as retain documentation showing how it took these factors into account in its ability-to-repay determination.

The CFPB indicates that this "this documentation may include, for example, an underwriter worksheet or a final automated underwriting system certification, in combination with the creditor's applicable underwriting standards and any applicable exceptions described in its policies and procedures, that shows how these required factors were taken into account in the creditor's ability-to-repay determination."

Verify Requirement and Safe Harbor

The rule does *not* prescribe specific methods of underwriting that a creditor must use, as long as the creditor uses third-party records that provide reasonably reliable evidence of the consumer's income or assets. Indeed, the rule permits the creditor to use any "reasonable verification method and criteria."

Nevertheless, in an especially significant provision of the rule, the CFPB provides a "safe harbor" to creditors using verification standards from relevant provisions from Fannie Mae's Single Family Selling Guide, Freddie Mac's Single-Family Seller/Servicer Guide, FHA's Single Family Housing Policy Handbook, the VA's Lenders Handbook, and the Field Office Handbook for the Direct Single Family Housing Program and Handbook for the Single Family Guaranteed Loan Program of the USDA. In other words, under the rule, a creditor is deemed to have complied with this verify requirement if it complies with the verification standards in one or more of these agency manuals.

In fact, the rule permits the creditor to "mix and match" verification standards from different agency manuals. Stated another way, the creditor is deemed to comply with the verify requirement if it complies with one or more of the verification standards of the manuals. Again, creditors are not required to verify income and debt according to the standards the CFPB specifies.

Treatment of Certain Five-Year ARM Loans

Under the rule, the CFPB creates a special provision for adjustable rate mortgages (ARMs) with initial fixed-rate periods of five years or less. In these transactions, the interest rate may or will change within the first five years after the date the first regular periodic payment will be due.

For purposes of determining whether these ARMs are accorded QM status, the creditor is required to ascertain the APR by treating the maximum interest rate that may apply during that five-year period as the interest rate for the full term of the loan. As an illustration, the rule provides:

> For example, assume an adjustable-rate mortgage with a loan term of 30 years and an initial discounted rate of 5.0 percent that is fixed for the first three years. Assume that the maximum interest rate during the first five years after the date on which the first regular periodic payment will be due is 7.0 percent. Pursuant to [the rule], the creditor must determine the annual percentage rate based on an interest rate of 7.0 percent applied for the full 30-year loan term.

Takeaways

On its face, the final rule appears to significantly alter the criteria for QM loans and seemingly diminishes the presence of the GSEs in the QM market. In eliminating the QM Patch, Appendix Q, and the hard 43% DTI threshold, the rule gives a creditor certain flexibility in originating QMs as long as it underwrites the loans using the specified consider and verify standards.

Ironically, the much-maligned Appendix Q provided a recognized measure of certainty of compliance with the QM underwriting rules if the creditor could adhere to its sometimes-arbitrary standards. Further, for GSE-conforming loans, as long as the loan was eligible to be purchased by Fannie Mae or Freddie Mac, and otherwise met the product feature and point/fee limits, the loan was automatically deemed QM.

Under the final rule, however, unless the creditor avails itself of the safe harbor for verifying the consumer's income, assets, debt obligations, alimony, and child support, the creditor's underwriting of the loan to achieve QM status is inherently subjective, and hence, at least initially may not be accorded the same recognition in the secondary market as a loan that had been underwritten to Appendix Q or had been subject to the QM Patch under the existing rule. Consequently, as the rule is implemented, creditors will be strongly incentivized to avail themselves of the safe harbor by complying with the verification standards of one or more of the agency manuals. Perhaps the revised rule will *not* diminish the presence of the GSEs in the QM market as anticipated.

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