REDWOOD TRUST

The New Qualified Mortgage Rules:

What are they and what impact will they have?

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During the final months of the Trump Administration, the CFPB announced a series of updates to rules[1] affecting the non-Agency mortgage finance market, including the GSE Patch, the QM rules, and rules affecting seasoned QM loans. We refer in this paper to these rules as the "Temporary GSE Patch Final Rule", the "Revised Final Rule" and the "Seasoned QM Final Rule" respectively.

In early March 2021, during the first weeks of the Biden Administration, the Revised Final Rule and Seasoned QM Final Rule went into effect. While the timing and full extent of the impact of these rules are not yet fully clear[2], these developments were welcomed by many participants in the mortgage finance industry, because they suggest a more level playing field between the public and private mortgage sectors may be on the horizon.

This brief paper is being issued by Redwood Trust, a leader in expanding access to housing for homebuyers and renters, to share our understanding of the state of play regarding the rules defining Qualified Mortgages and the potential impact on the market.

We're offering perspective now because many participants in the mortgage market are still trying to determine how the new Revised Final Rule might change the way mortgages are underwritten and what opportunities and considerations it might create for investors. The output of these determinations will ultimately be felt by borrowers, both in the steps required to procure a mortgage and, by extension, borrowing costs. With the early 2021 guidance from the CFPB that it may "revisit" the Revised Final Rule, industry participants would greatly benefit from some clarity since such rule is currently in effect.

Current Status

At the time of this writing, the market is at an interesting juncture with regards to the QM definition. As noted, the Revised Final Rule

[1] In July 2019, the Consumer Financial Protection Bureau (CFPB) issued an Advanced Notice of Proposed Rulemaking (ANPR) indicating it would let the so-called Government-Sponsored Enterprise (GSE) Patch expire in January 2021, and sought information on possible amendments to the Bureau's Ability to Repay/Qualified Mortgage (ATR/QM) rule that has been in effect since The Dodd-Frank Wall Street Reform and Consumer Protection Act amended the Truth in Lending Act (TILA) to establish ability-to-repay requirements for most residential mortgage loans. This was followed by the CFPB's issuance of a separate notice of proposed rulemaking (NPRM) in August 2020 to create a new category of seasoned qualified mortgages (Seasoned QMs). In October 2020, the CFPB issued a final rule to extend the GSE Patch (the "Temporary GSE Patch Final Rule"). This was followed by the CFPB's issuance of two additional QM-related final rules in December 2020. Of the two final rules from the Bureau, one drastically simplifies the definition of a QM (the "Revised Final Rule") and the other provides an alternative pathway to QM safe harbor status for certain seasoned mortgage loans (the "Seasoned QM Final Rule"). The Revised Final Rule was designed to replace the current requirement for general QM loans that the consumer's debt-to-income (DTI) ratio not exceed 43% with a limit based on the loan's pricing. In adopting a price-based approach to replace the specific DTI limit for General QM loans, the Bureau determined that a loan's price is "a strong indicator of a consumer's ability to repay and is a more holistic and flexible measure of a consumer's ability to repay than DTI alone."

[2] The acting leadership of the CFPB announced it may reconsider the Revised Final Rule and, in any event, pushed back its mandatory compliance date. The CFPB also announced that it may also reconsider the Seasoned QM Final Rule.

was slated to go into effect in early March 2021, but almost immediately rumors began to swirl that the CFPB, under new leadership, intended to delay the original mandatory compliance date of July 1, 2021. In late February those rumors were confirmed, as the CFPB released a notice of proposed rulemaking (NPRM) to delay mandatory compliance with the Revised Final Rule to October 1, 2022. These dueling "mandatory compliance" dates have put originators in the somewhat unique position of having a choice (for an extended period of time) of whether to apply the new or old guidelines.

Without greater certainty surrounding the direction of the new rules, consumers may experience a further delay in the re-emergence of certain non-agency loan products. With that concern in mind, let's understand this new rule and its implications if it ultimately becomes the true law of the land for QM determination.

What the New Revised Final Rule Says (and What It Doesn't Say)

The Revised Final Rule retains the product limitations on QM (for instance, interest-only and negative amortization loans still don't qualify as QM), as well as the cost thresholds for determining if a loan is QM. However, as noted above, the new rule removes the strict 43% DTI ratio cutoff in favor of a market-based spread at origination relative to the Average Prime Offered Rate (APOR). APOR is a baseline market mortgage rate from which a loan's credit risk can be imputed based upon the loan's annual percentage rate (APR) relative to this benchmark. In other words, the new rule eases up on one strict formulation for determining a mortgage loan's eligibility to be deemed a Qualified Mortgage. It replaces a borrower-specific DTI calculation with an alternative (and simpler) market-based approach for determining whether a loan can be considered a QM.

The new rule also retains the two categories of QM: loans where the originator is presumed to have met the ATR requirements of the QM rule and thereby receives a safe harbor in potential litigation ("Safe Harbor QMs"), and loans where the borrower has the ability to rebut that presumption in court ("Rebuttable Presumption QMs").

This is where the market spread methodology comes in: under the Revised Final Rule, a loan's spread to APOR is now the key determinant of QM status. Loans with APRs less than 150bps above APOR and that meet the originator's underwriting guidelines for ATR will qualify as Safe Harbor QMs. Loans with APRs between 150bps and 225 bps above APOR will qualify for Rebuttable Presumption QMs. Lastly, loans with rates greater than 225bps above APOR do not qualify (non-QM).

The Likely Impact of the New Revised Final Rule

We believe the Revised Final Rule will marginally level the playing field between the non-Agency and Agency markets by providing flexibility to non-Agency underwriters in determining a borrower's ATR. This leeway has previously only been enjoyed by the GSEs. If this rule survives, it will likely lead to increased credit availability, more loans classified as QM, and increased competition among lenders. For these reasons, the rule change has been widely lauded by mortgage originators. However, some industry participants had hoped to see a level playing field while retaining the existing ATR criteria. In specific: require the GSEs to comply with the standards already in effect for the private sector.

What About Appendix Q?

In the original QM rule, the standards to determine and document the income used to calculate DTI were found in Appendix Q of 12 CFR Part 1026, also known as Regulation Z, which implements the Truth in Lending Act. Based on traditional Federal Housing Administration (FHA) lending guidelines, Appendix Q was rather strict and doctrinaire, but also vague in dealing with non-traditional sources of income (such as commission income or restricted stock units). As a result, this portion of the rule came under increased criticism from the mortgage industry, particularly as non-traditional sources of income became increasingly common during the underwriting process.

The Revised Final Rule removes Appendix Q, so lenders will have more flexibility going forward to establish their own methodologies for certain underwriting approaches, including calculating and documenting income, and verifying employment and assets. The existence of Appendix Q made sense under the original QM rule, where a strict DTI threshold required a common, formalized methodology across originators, so that one borrower's DTI was comparable to another's (at least for purposes of determining QM status).

However…

The Revised Final Rule still requires that originators make a reasonable, good-faith determination of a borrower's ability to pay, before or at the time a mortgage loan is consummated, and that the consumer has the wherewithal to perform under the terms of the loan. In other words, it still requires that lenders have a methodology to support their determination of a borrower's ATR. The Revised Final Rule also requires that originators still "consider DTI" in their methodology.

What this means in practice is that with the removal of Appendix Q, originators will have flexibility around what they consider and how they verify/document a borrower's ability to repay the loan. A methodology of some form, however, needs to be in place.

Seasoned Loans

Under the Seasoned QM Final Rule, the provision for seasoned non-QM loans is very limiting. Loans that are priced between 150bps and 225bps above the APOR start out with rebuttable presumption status, but over time can qualify for safe harbor status if they meet certain delinquency and performance thresholds during the first 36 months post origination. The provision for seasoned non-QM loans favors whole loan trading versus securitization, as the rule does not allow non-QM loans in securitizations to benefit from seasoning.

Market Impact

There's a reason why no consensus has yet emerged on the market impact, as the Revised Final Rule is long, complicated and has some potentially offsetting elements. What we do know is that more flexibility in underwriting generally leads to a loosening of credit standards, and thereby tends to lead to more volume - potentially the highest order impact of the new rule.

This increased flexibility will likely result in loans that would previously be deemed non-QM qualifying as QM going forward. A corresponding reduction in non-QM lending will follow, making growth difficult for monoline origination platforms previously focused largely on non-QM lending, as compared to full-service originators offering a broader suite of loan products. Lower volume may also constrain the availability of dedicated warehouse facilities for non-QM loans and could extend aggregation periods for dedicated non-QM securitizations.

Impact on Risk Retention in Non-Agency Mortgage Securitizations

Just to add one more layer of complication, we should remind readers that the original idea of a QM was created to help define a borrower's ability to repay a loan. Since regulators have a dual mandate of protecting borrowers and investors, the category of a Qualified Residential Mortgage (QRM) was also created to determine which loans are subject to risk retention by the sponsor of a securitization. Risk retention requirements compel a sponsor to retain (in specified forms) 5% of the underlying value of the securitization for at least several years, and therefore have important ramifications on loan pricing. For a non-agency mortgage securitization to be exempt from risk retention requirements, every loan in the underlying pool must be QRM (the inclusion of a single loan that is not QRM triggers a full risk retention obligation on the part of the sponsor).

Mercifully, regulators set these definitions as the same, meaning a QM is a QRM for purposes of risk retention requirements. The market often uses these terms interchangeably, although they technically aren't. If these definitions diverge in the future (and, say, the QRM definition becomes tighter), this will impact the non-agency securitization market and therefore how certain cohorts of loans are originated and priced. This includes loans made on non-owner occupied properties, more of which may find their way into the non-agency market based on a recently-announced cap on purchases of these loans (plus loans made on second homes) by the GSEs.

What About the GSEs?

The combination of the Temporary GSE Patch Final Rule and the Revised Final Rule ends the "QM patch", which provided the GSEs with an exemption from complying with the 43% DTI cap and Appendix Q underwriting standards. The QM patch basically said that if a loan is underwritten to GSE guidelines, the loan by definition is a QM. This was one of many factors making GSE loans easier and cheaper to underwrite relative to non-Agency.

Without this exemption, originators selling to GSEs will now have to underwrite to QM guidelines that they develop and can defend, although the Revised Final Rule makes it easier for originators to do this in one important way: by adopting GSE or FHA guidelines. This may have an important impact on the speed with which the non-agency market adopts certain elements of automated underwriting present in GSE processes.

Does Everyone Now Get to Use GSE Guides?

That's one way to look at it, but let's be more specific: The Revised Final Rule allows an originator to use GSE or FHA standards to underwrite a loan and satisfy ATR requirements. Effectively this means that GSE standards are QM under both the old and new QM rules. Now, however, the private sector can adopt those standards and satisfy QM as well - the more level playing field we referenced earlier. The ability for the private sector to adopt or even modify GSE standards will allow for flexibility and creativity among originators in creating new standards, some of which might even be adopted by the GSEs.

Housing Policy Impact

There are inherent conflicts and tradeoffs for policymakers focused on expanding credit availability while also protecting consumers and investors from undue risk. That's not an easy balance to strike.

As we have discussed, the idea of a qualified mortgage is based upon a borrower's ability to repay the loan, an absolute standard that lends itself to quantitative measures such as DTI. The Revised Final Rule, however, is focused on the interest rate of the loan relative to a market benchmark. Mortgage rates are determined by supply and demand, and competitive capital markets forces. Therefore, a loan's spread to a benchmark - determined as it is by these market dynamics – is a relative measure, not an absolute measure. DTI is an absolute measure of a borrower's debt burden relative to the income they earn. If the objective of the ATR requirements is to measure a specific borrower's absolute ability to pay - not relative to someone else's - then it seems as if a DTI measure (in some form) would be a more appropriate assessment tool given that it is not influenced by unrelated market forces.

That said, the Revised Final Rule, if it remains the policy of the CFPB, we believe will generally make credit more available to the marketplace and will increase the availability of credit as a whole.

Practical Implications of the Policy Uncertainty

As it stands now, originators can adopt the new policy or stick with the old one until the CFPB completes its latest rulemaking initiative. In our view, the prospect of this type of "stub period" will create challenges for market participants, namely the liquidity and salability of loans measured against what may be a short-term standard. As a result, many market participants may choose not to change their underwriting guidelines and infrastructure until a final determination is made by the CFPB.

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