

Client Alert

September 2020

CFPB Proposes Significant Changes to Regulations Governing Qualified Mortgages

Qualified mortgages (QMs) were at the forefront of the CFPB's rulemaking agenda this summer. In a span of three months, it issued three separate Notices of Proposed Rulemaking (Proposals) that would make significant changes to the QM requirements under Regulation Z's Ability to Repay/Qualified Mortgage Rule (ATR/QM Rule).

First, in June 2020, the CFPB issued a proposed rule that would update the definition of a "General QM" (described more fully below) to remove the 43% DTI requirement (and Appendix Q) and replace it with a price-based test. Simultaneously, the CFPB proposed to extend the "GSE Patch" until a final rule updating the General QM definition goes into effect.

On the heels of these changes, the CFPB proposed in August 2020, to create a new "Seasoned QM" category, which would provide an alternative pathway to QM safe-harbor for certain loans that meet specified performance metrics after being held in the creditor's portfolio for at least 36 months. Below, we provide background on the CFPB's rulemaking in this area and a summary of each Proposal.

Background on CFPB's Proposals

The CFPB's ATR/QM Rule, which took effect in January 2014, requires that for most residential mortgage loans, creditors must make a reasonable, good faith determination at or before consummation of a consumer's ability to repay the loan according to its terms. One way for creditors to comply with the ability to repay (ATR) standards and to receive protection from liability is to originate a Qualified Mortgage (QM). This category includes General QMs and Temporary QMs, QMs as implemented by HUD, VA, and USDA, and several types of QM available only to small creditors, such as the Small Creditor Portfolio QM.

Under the General QM definition, a borrower's DTI ratio may not exceed 43%. A creditor is also required to consider and verify the borrower's income and debt obligations under the standards set forth in Appendix Q. The industry has consistently grappled with Appendix Q, which is regarded as outdated and difficult to apply with respect to non-traditional income in the case of gig-workers and self-employed borrowers.

The Temporary QM category affords QM status to loans that are eligible to be purchased or guaranteed by Fannie Mae or Freddie Mac (referred to as the "GSE Patch"). Notably, the QM Rule prescribes no maximum DTI for Temporary QMs as long as the loan meets the criteria of the GSEs, and a creditor need only use GSE standards, and not Appendix Q, to consider and verify debt and income.

The GSE Patch is set to expire on January 10, 2021, or when the GSEs exit conservatorship, whichever comes first. Last year, the CFPB indicated that it planned to allow the GSE Patch to expire in early 2021, or after a short extension for an orderly transition away from the Temporary QM definition.¹

¹ Qualified Mortgage Definition Under the Truth in Lending Act (Regulation Z), 84 Fed. Reg. 37,155 (July 31, 2019).

At the time the ATR/QM Rule was implemented, the CFPB believed that the prevalence of Temporary QMs would decrease over time as the market shifted to General QMs and non-QMs. However, contrary to these expectations, Temporary QMs continue to represent a “large and persistent” share of originations in the conforming mortgage market.² Accordingly, the CFPB contemplates that after the GSE Patch expires, a significant number of Temporary QMs will not qualify as General QMs either because the DTI ratio exceeds 43% or because the creditor’s methods for documenting and verifying income does not comply with Appendix Q.³ The CFPB indicates that this could result in a significant reduction in the QM market and could significantly reduce access to responsible, affordable credit.⁴ Accordingly, the CFPB proposes to modify the definition of a General QM to replace the DTI threshold with a price-based approach and extend the sunset date of the GSE Patch until these updates take effect.

Updating the General QM Definition

On June 22, 2020, the CFPB published a Proposal that would amend the General QM definition by removing the 43% DTI limit, along with Appendix Q, and replacing it with a price-based approach. According to the CFPB, a price-based approach “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.”⁵ In addition, removing a specific DTI requirement could foster new technology in the underwriting process to assess ability to repay, potentially expanding access to affordable credit for applicants with non-traditional and limited credit history.⁶

The Proposal retains, but updates, the “consider and verify” requirements, and provides that a creditor must consider DTI or residual income. The CFPB proposes to remove Appendix Q “because its definitions of debt and income are rigid and difficult to apply and do not provide the level of compliance certainty” anticipated when the ATR/QM Rule was implemented.⁷

As proposed, a loan would meet the General QM definition if the APR exceeds the average prime offer rate (APOR) for a comparable transaction by less than 2%. The rule provides higher thresholds for smaller loan amounts and subordinate lien loans. The Proposal includes a special rule for determining APR for so-called “short-reset ARMs” where the interest rate can or will change within 5 years of the first payment due date. For those loans, the APR would be calculated by treating the maximum interest rate that may apply at any time during the first 5 years as the interest rate for the full term of the loan. Industry commenters have noted that this may result in a larger percentage of 3 and 5 year ARMs becoming non-QM loans.

General QM loans would still have to meet the QM Rule’s product-feature, underwriting requirements, and limits on points and fees. A creditor would be required to consider income or assets, debt obligations, alimony, child support, and monthly DTI ratio, or residual income, and verify income or assets and debt, alimony, and child support under the existing ATR verification standards. While the Proposal does not mandate a specific method for verifying debt and income, it would provide a safe harbor to creditors using verification standards that would be specified in the final rule (such as the guides of Fannie Mae and Freddie Mac and the handbooks of FHA, VA, and USDA) and would allow creditors to “mix and match” these standards. The CFPB also indicates it would be open to reviewing verification standards developed by stakeholders for potential inclusion in the safe harbor.

The Proposal does not change the current standards that separate safe harbor QMs from rebuttable presumption QMs (i.e., a loan is a safe harbor QM if its APR exceeds APOR for a comparable transaction

² Qualified Mortgage Definition Under the Truth in Lending Act (Regulation Z): General GM Loan Definition, 85 Fed. Reg. 41,716 at 41,721 (July 10, 2020).

³ *Id.* at 41,716.

⁴ *Id.* at 41,717.

⁵ *Id.* at 41,717.

⁶ *Id.* at 41,728.

⁷ *Id.* at 41,729.

by less than 1.5% for first lien loans or less than 3.5% for subordinate lien loans), although the CFPB does solicit comments on whether it should adopt higher or lower safe harbor thresholds.

The CFPB solicits comments on numerous issues throughout the Proposal, including alternative approaches that would retain a specific DTI limit but raise it above 43% and provide a more flexible set of standards for verifying DTI in place of Appendix Q. With respect to Small Creditor QMs and Balloon Payment QMs, the Proposal would make conforming changes to these provisions, but not change the existing substantive requirements.

The new General QM definition would be effective six months after publication in the Federal Register and would apply to applications taken on or after this date (the Proposal does not set forth a specific definition of “application”). The CFPB indicated it does not intend to issue a final rule early enough for it to take effect before April 1, 2021, and solicited comments on whether there is a day of the week or time of the month that would most facilitate the implementation of the proposed changes. Comments on the General QM Proposal were due by September 8, 2020.

Sunset of the GSE Patch

To ensure an orderly transition away from the GSE Patch, the CFPB proposes to extend the GSE Patch until a final rule updating the General QM definition goes into effect.⁸ The GSE Patch would continue to apply to loans consummated on or before the earlier of the GSE’s existing conservatorship or the effective date of the final rule amending the General QM definition.

As flagged by several industry commenters, the proposed timing of the GSE Patch sunset and the effective date of the new General QM definition would result in a gap in coverage for borrowers that apply for a loan prior to the effective date of the new general QM definition, but whose loans close after the GSE Patch has expired. One way to address this would be to extend the GSE Patch for an additional period of time following the implementation of the new General QM definition. Comments on the GSE Patch extension were due by August 10, 2020.

New “Seasoned QM” Category

The CFPB’s most recent Proposal, issued August 18, 2020, would create a new QM category called “Seasoned QMs,” citing precedent created by the GSE representation and warranty framework. A non-QM loan or a rebuttable presumption QM loan could become a safe harbor QM after being held in the creditor’s portfolio for a 36-month seasoning period, provided the loan also meets certain requirements related to performance, loan features, and underwriting.⁹

To qualify, the loan must be a first-lien, fixed rate, fully amortizing loan, and comply with other criteria applicable to QMs, such as the points and fees requirement. As with Small Creditor Portfolio QMs, a lender must consider DTI or residual income and verify the debt obligations and income used in this calculation, but need not adhere to a specific DTI ratio or use Appendix Q. ARMs, step-rate mortgages, and mortgages with balloon payments would not be eligible for seasoning treatment.

In terms of performance, the loan may not have more than two delinquencies of 30 or more days and may have no delinquencies of 60 or more days at the end of the seasoning period. The “seasoning period” means a period of 36 months beginning on the date on which the first periodic payment is due after consummation. To address concerns about potential “gaming” by creditors during the seasoning period, payments from escrow and payments from a creditor, assignee or servicer, or a person acting on these

⁸ Qualified Mortgage Definition Under the Truth in Lending Act (Regulation Z): Extension of Sunset Date, 85 Fed. Reg. 41,448 (July 10, 2020).

⁹ Qualified Mortgage Definition Under the Truth in Lending Act (Regulation Z): Seasoned QM Loan Definition, 85 Fed. Reg. 53,586 (August 28, 2020).

parties' behalf, would not be considered in assessing delinquency (except for making up a deficiency of \$50 or less).

If there is a delinquency of 30 days or more at the end of the seasoning period, then the seasoning period ends when there is no delinquency. In addition, temporary payment accommodations (such as a trial loan modification plan, temporary payment forbearance program, or temporary repayment plan) extended in connection with a disaster or pandemic-related national emergency are not considered delinquencies, provided that during or at the end of this temporary payment period, there is a "qualifying change" (i.e., an agreement that meets certain criteria) or the consumer cures the loan's delinquency under its original terms. However, temporary payment accommodations would pause the seasoning period, meaning that it must be satisfied by the periods immediately before and after the accommodation period.

To satisfy the portfolio requirements, the loan may not be subject to a commitment to be acquired by another person at consummation. Furthermore, legal title of the loan may not be sold, assigned, or otherwise transferred to another person before the end of the seasoning period (subject to two exceptions, one for certain supervisory sales and the other for mergers).

As proposed, the Seasoned QM provisions would take effect on the same day as the final rule amending the General QM definition. Only loans for which a creditor receives an application on or after the effective date of the final rule would be eligible for Seasoned QM status (in other words, loans that are in existence prior to the effective date could not qualify for this seasoning treatment). Comments on the Seasoned QM Proposal are due October 1, 2020.

Takeaways

As a whole, the CFPB is proposing a significant overhaul in the QM space that has the potential to bring more loans under the QM umbrella and reduce litigation risk for creditors and their assignees. Since QMs enjoy either a safe harbor or a rebuttable presumption of compliance with the ATR standards, a price-based General QM definition, coupled with more flexible verification standards, would expand the number of loans eligible for General QM status and provide more compliance certainty that loans meet the QM requirements.

If a Seasoned QM category is added, this has the potential to reduce long-term ATR risk for creditors and assignees. For loans originated as non-QMs or rebuttable presumption QMs, borrowers would still have 3 years to bring a private action for an ATR violation, but once a loan seasoned into a safe harbor QM, a borrower's right to assert an ATR violation as a defense to foreclosure by recoupment or setoff would also be limited to 3 years.

It appears that the CFPB is pushing for a relatively quick turnaround time for issuing a final rule on the General QM definition (which in turn would determine the sunset date for the GSE Patch). As noted above, the CFPB has indicated that the final rule would be effective 6 months after publication in the Federal Register, and the earliest effective date would be April 1, 2021. To achieve an effective date this early, the CFPB would need to publish its final rule by the beginning of November 2020, which is less than 2 months away. The CFPB did note in its General QM proposal that according to industry commenters, removing DTI and replacing it with a price-based approach would require a relatively short implementation period given that it is largely a simplification of the existing General QM construct.¹⁰

Of course, one driver of this timing is that absent any extension, the GSE Patch will expire this January. Another potential factor is the upcoming presidential election. Given the Supreme Court's June 2020 decision holding the CFPB's leadership by a single director removable only "for cause" to be unconstitutional, the CFPB director is now removable by the president for any reason, meaning that the

¹⁰ Qualified Mortgage Definition Under the Truth in Lending Act (Regulation Z): General GM Loan Definition, 85 Fed. Reg. 41,716 at 41,725 (July 10, 2020).

results of a presidential election have the potential to impact the CFPB's leadership, and therefore its regulatory agenda.¹¹ We will continue to monitor these QM rulemakings and provide updates.

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¹¹ *Seila Law LLC v. Consumer Financial Protection Bureau*, 591 U.S. ____ (2020). The Supreme Court also held that these removal provisions are severable from the CFPB's other authorities, leaving the agency intact.