D.C. OUTLOOK: Mortgage Lending

January is month when all parts bolt together--maybe

This article is an online companion to the January 2013 ABA Banking Journal cover story, "The Road Ahead." To read that article and other online articles in the report, please click here.

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By Steve Cocheo, executive editor & digital content manager

This month those comical greeting card characters Hoops and Yoyo, on their website, sing the song "Janu-worry." And if you didn't know they were goofy cartoon characters, you might mistake them for mortgage lenders.

That's because January 2013 is the month the Consumer Financial Protection Bureau has committed to deliver a slew of final regulations, mandated by the Dodd-Frank Act, that will remake the way the mortgage business works. Along with the expected and the dreaded, have been surprises--the latter including a proposal to exempt smaller community banks from some of one of the new regulations. A huge amount of regulation in final form has been delivered to the industry's doorstep during the month, with analysts and bankers still poring through it all.

"QM" leads the flood for 2013

January 10 the first of the flood came through, the "qualified mortgage" regulation, or "QM," in the current shorthand, with its key "ability-to-repay" rule. While aspects of this 804-page regulation, and some of the other regulations since delivered, began gestating at the Federal Reserve, QM bears the stamp of CFPB.

The impact of the QM rule, and elements of much of the rest, will be to corral mortgage lending. ABA has achieved key goals, among them: keeping the qualified mortgage definition relatively broad; establishing safe harbor legal protections and postponing; and perhaps preventing, "all-in" APR requirements. Nevertheless, significant flaws are to be expected in the complex rules. Some flaws will be corrected, and others will challenge the industry. Overall, expect the rule to change the face of the business as well.

"In the future, there are going to be no high-risk mortgage assets," predicts Bob Davis, ABA executive vice-president, mortgage markets, financial management, and public policy. This will affect mortgage lending not only at the front-end, where the lender meets the borrower, but throughout the lending, portfolio, and secondary market processes.

There certainly were high-risk mortgages-subprime mortgages-prior to the crisis, says Davis. "But in the future the qualified mortgage and the ability to repay standards apply to every loan underwritten, whether for portfolio or for sale. There will be much more homogeneity in pools of mortgages because the underlying assets will all be driven by essentially the same underwriting standards, dictated by the QM rule."

Not an accident

What Davis describes isn't one of the often spoken of "unintended consequences" of Dodd-Frank--it's quite by design. The preamble to the final QM rule states:

"During the years preceding the mortgage crisis, too many mortgages were made to consumers without regard to the consumer's ability to repay the loans. Loose underwriting practices by some creditors--including failure to verify the consumer's income or debts or qualifying consumers for mortgages based on ‘teaser' interest rates that would cause monthly payments to jump to unaffordable levels after the first few years--contributed to a mortgage crisis that led to the nation's most serious recession since the Great Depression. ... [Under Dodd-Frank] Congress required that for residential mortgages, creditors must make a reasonable and good faith determination based on verified and documented information that the consumer has a reasonable ability to pay the loan according to its terms."

Importance of the QM regulation

While the entire body of Dodd-Frank mortgage regulation is important, ABA has long considered the QM rule to present the greatest risk of transforming the mortgage markets and potentially changing the viability of the business and the availability of housing credit. (ABA's Mortgage Market Committee's regulatory reform working group will be examining the final regulation in depth to help banks best work with it. To join the working group, contact ABA's Rod Alba.)

The implications for the markets are significant--and better understood in light of what the final QM regulation, effective--like most of the Dodd-Frank mortgage regulations--in January 2014.

Basics of CFPB's QM rule

In a nutshell, a qualified mortgage, under Dodd-Frank, is one that does not include certain risky features and does not exceed certain pricing restrictions, in a nutshell.

Beyond the nutshell, there are many details.

A core element of the QM rule is the ability-to-pay standard, which consists of eight elements mortgage lenders must use in underwriting, relying on reliable third-party information sources as much as possible to verify each:

- • Current or reasonably expected income or assets--gone are no-income-check and no-asset-check mortgages.

- • Current employment status.

- • Monthly payment on the mortgage.

- • Monthly payment on any simultaneous loan.

- • Monthly payment for mortgage-related obligations.

- • Other current debt obligations, as well as alimony or child support.

- • Monthly debt-to-income ratio or residual income.

- • Credit history.

The rule also assumes a qualified mortgage will typically require equal monthly payments during its term, and be calculated based on the highest payment that will apply in the first five years of the loan. For adjustable-rate mortgages, the payment must be calculated using the fully indexed rate, or an introductory rate, whichever is higher.

To meet the QM standards the borrower must have no greater than a 43% total debt-to-income ratio after receiving their mortgage. (Higher ratios may be permitted in some circumstances, but the 43% standard applies for the automatic presumption of the lender's "safe harbor," covered below.)

Generally speaking, the rule excludes from qualified mortgage status the loans with negative amortization features; interest-only payments; balloon payments; and terms exceeding 30 years. In press materials, CFPB refers to these elements as "toxic loan features." In addition, a loan where borrower points and fees exceed 3% of the total loan amount will not be considered a qualified mortgage.

Special version of QM included

An alternative means to establish qualified mortgage status is provided for an interim period. During this period loans that have more flexible underwriting standards that satisfy two conditions. First, they must have the certain general product feature requirements for a qualified mortgage. Second, they must meet the underwriting standards of, and be eligible for, purchase, guarantee, or insurance by Fannie Mae or Freddie Mac (while under U.S. conservatorship) or the mortgage programs of the Federal Housing Agency, the Department of Veterans Affairs, or the Department of Agriculture or the Rural Housing Service. This special provision goes away after seven years, or sooner when the agencies mentioned develop their own QM rules.

Part of the reason for this special provision is to encourage lenders to continue to make certain loans with debt-to-income ratios above 43% limit. ABA members surveys indicate that under market practices about 15% of loans are being made above 43% DTI. CFPB explains the need for the special QM treatment this way: "In light of the fragile state of the mortgage market as a result of the recent mortgage crisis, ... the Bureau is concerned that creditors may initially be reluctant to make loans that are not qualified mortgages, even though they are responsibly underwritten."

Special provisions also would apply to certain balloon payment mortgages made by smaller creditors in rural or underserved areas, subject to conditions. Among the requirements for this treatment would be the need to hold the loans in portfolio for three years. Rural and underserves areas include all counties except those in metropolitan statistical areas or counties adjacent to these areas.

QM, lawsuits, and safe harbor

Under the Truth in Lending Act, as amended by Dodd-Frank, a consumer can sue a lender for violating the ability-to-pay standards, subject to restrictions. The new regulation spells out the potential penalties and other amounts a lender may be sued for. In addition, the longer the consumer has been paying the mortgage as contracted, the less likely they will be able to attack the lender in court, according to CFPB's summary of the QM rule.

Under the Dodd-Frank Act, and as implemented in the QM rule, there is a "safe harbor." There is a "presumption of compliance" for qualified mortgages. A loan priced under 150 basis points above the average prime offer rate and satisfies QM criteria will be conclusively presumed in compliance with ability to repay standards.

"If the loan goes south," CFPB states, "the lender will be considered to have legally satisfied the ability-to-repay requirements. But consumers can still legally challenge their lender under this rule if they believe that the loan does not meet the definition of a Qualified Mortgage."

Higher-priced loans will not have the same protection. In this case, "if the loan goes south," CFPB states in its press summary, "the consumer can rebut the presumption that the creditor properly took into account their ability to repay the loan." CFPB refers to these as "qualified mortgages with a rebuttable presumption."

For a detailed staff analysis of the QM rule, ABA members can click here [PDF].

A break for community banks?

Along with the final rule, CFPB issued proposed amendments to the ability-to-repay rules. These generally would apply to affordable housing and community development programs and foreclosure prevention programs.

However, there is also a provision that could give QM status to loans made for portfolio by community institutions--defined as those under $2 billion in assets that make 500 or fewer first-lien mortgages per year.

The proposal also raises the possibility of permitting such lenders to charge more in upfront points "in light of the fact that small creditors often have higher costs of funds than larger creditors" and to charge somewhat higher rates. In part, the rationale described takes into account community lenders' typical model of relationship lending, rather than transactional lending. The Bureau proposal was intended to help avoid a reduction of mortgage credit for consumers served by these lenders.

ABA launched a new working group specifically on this new proposal. The group will consider preliminary options, and then develop recommendations on the proposal's scope of activities, the characteristics of institutions it should cover, and the extent of the relief it should provide.

The deadline for comments is Feb. 25. To join the group, contact ABA's Alex Maroullis-Cronmiller.

More regulations here or on the way

As ABA's Bob Davis points out in the January ABA Banking Journal cover story, "The Road Ahead," there are so many regulations, and so many players involved, there is concern that when "they come to bolt all the modules together, that plane's not going to fly."

"I don't fault the regulators--they've been given an impossible task in Dodd-Frank," says Davis. "A good bit of 2013 will be identifying rough spots and places where the bolts don't fit, and then trying to get the regulators to make adequate adjustments even before the effective dates."

When the QM rule was issued on January 10, CFPB also issued two more of the final regulations that have been waiting in the wings.

One expands the coverage of the Home Ownership and Equity Protection Act to include both home-purchase loans and home equity lines of credit. HOEPA defines what a "high-cost mortgage" is, using rate thresholds based on the average prime offer rate for each category of loan. Thresholds for points are also included. The new regulation also addresses limits on late fees, and various other facets of loan pricing. The regulation also imposes homeownership counseling before a consumer can engage in a high-cost mortgage. (HOEPA was originally enacted in the 1990s, to address pricing of closed-end home-equity loans and refinancing.)

ABA achieved one of its aims in commenting on this regulation while it was being developed: CFPB removed a section that would have required a major revision to APR calculations, the proposed "all-in" approach.

This hasn't gone away, however. CFPB is still working on a proposed combination of the Truth in Lending and Real Estate Settlement Procedures Act regulations, and said that the matter could be addressed as part of those discussions.

Regarding that project, ABA's comments on the 1,100-page merger of the two sets of rules were based on an overall view that it "neither meaningfully simplifies the disclosures, nor considers other ongoing reforms that affect mortgage originations." The association urged CFPB to delay the project until all the other mortgage-related regulatory changes had been implemented and their impact assessed. Unlike other aspects of Dodd-Frank mortgage reform, this one does not have a set deadline.

At the same time that the QM and HOEPA regulations were issued, CFPB put out regulations changing escrow account requirements for high-priced mortgages, increasing the required maintenance of an escrow account to five years from one year. Both this and the HOEPA expansion provide exceptions for institutions offering balloon loans in rural and underserved markets, as addressed earlier. (The escrow rule goes into effect June 1, unlike many of the new regulations already proposed.)

Yet more final mortgage regulations were due out this month, by Jan. 21. Among them:

- • Servicing rules dealing with numerous servicer obligations to borrowers; including error correction; justification for force-placing insurance; and access to servicer personnel for delinquent borrowers, with "continuity of contact" regarding their loan.

Davis says the regulations as proposed are oriented much more to the problems and management challenges of very large servicing shops and could hurt community banks.

"You can't take a regime that was designed to deal with the inadequacies of a massive call center operation and try to apply it to a community bank servicer where the people who deal with problem loans are the same people who made the loans," says Davis. (Click here for a summary of the rules, which CFPB just finalized.)

- • Loan originator compensation rules that provide additional guidance on existing restrictions on mortgage lender pay and which would only permit lenders to extend mortgages with discount points and origination points and fees if they also offered a no-points alternative mortgage.

As proposed, Davis says, these rules are "convoluted." "They make it harder to run a mortgage business," he explains. CFPB issued the voluminous rules January 18. Initial reactions were that they were somewhat improved, and aimed most specifically at compensation dealing with "risky and high-cost loans, in CFPB's words.

- • Appraisal disclosures for first-lien mortgages, including the requirement to provide free copies of all written appraisals and valuations. These were adopted January 18.

- • Appraisal documentation for higher-risk mortgages. Click here to read the final regulation, issued as the page was being prepared.

Also in the mix, although not
subject to a statutory deadline like the above, is the "QRM"--qualified residential mortgage--regulation.

Where will QRM go?

QRM is tied up in the risk
retention debate that has gone on since Dodd-Frank's formative days. The intention was that lenders would retain an interest in mortgages sold, to give them "skin in the game." The concept: Lenders won't send poorly underwritten loans to the market if they still have their own money in the deal.

7-part ABA mortgage

regulation phone
briefings

begin Jan. 25 with
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for association
members

"A Whole New World: CFPB Re-Draws The Mortgage Regulatory Landscape," a new telephone briefing series from ABA, will help bankers drill down into the complex layers of the new mortgage rules summarized in this article.

January 25 ABA will present a members-only free briefing, "Understanding the Big Picture: Overview of CFPB Mortgage Rulemakings." This will include an overview of the six rules recently issued by the Consumer Financial Protection Bureau. Bankers will hear about potential impacts on banks' mortgage operations, with special emphasis on ability-to-repay requirements.

To learn more about the free ABA member briefing, click here.

The introductory briefing will be followed by a series of six more briefings that will go into much more detail about the regulations. Topics will include:

• Understanding ability-to-repay and QM, Feb. 12

• In-depth: Parsing CFPB's new servicing rule, Feb. 19

• HOEPA's expanded reach: "high-cost mortgages," Feb. 26

• Escrow and balloons: What's exempt and what's not, March 5

• Understanding mortgage loan originator compensation, March 12

• Appraisals, March 19

To learn about these briefings, and the member discounts available, click here.

Links to specific briefings will be posted as they become available. The link above also provides automatic update service which you can register for.

The original proposal on risk retention predates CFPB's official launch--the proposal was made by the Federal Reserve and five other agencies in April 2011. At the time, ABA criticized the proposal and called for a redraft. A key element is the "Qualified Residential Mortgage" concept, a category which would be exempt from the risk retention rules. At present, QRMs, as proposed, differ from QMs, as finalized. Among differences is the total back-end debt to income ratio permitted--under the QRM proposal, it would be 36%, while under the QM it is 43%. QRM also requires a 20% down payment by the borrower--QM is silent regarding down payments.

In the preamble to the QM regulation, CFPB notes that Dodd-Frank requires that the QRM be no broader than the QM, even though the two concepts arise from differing purposes.

"While the Bureau's qualified mortgage definition will set the outer boundary of a QRM, the QRM agencies have discretion under the Dodd-Frank Act to define QRMs in a way that is stricter than the qualified mortgage definition," CFPB stated.

The association has long expected the revised proposal to come out after the CFPB's QM standards. More recently, the status of the risk retention and QRM issues has grown hazier, due in part to the Basel III capital proposals that are under further discussion.

Davis points out that while QM is a lending rule, QRM is really a capital rule.

"QRM basically says that mortgages of certain characteristics you have to retain risk on--and that is just another way to say that you have to hold capital," says Davis.

QRM came out before Basel III and before U.S. regulators issued their substantially different proposed capital treatment for mortgage lending. "It makes no sense to go forward with QRM until you have some clarity with respect to what you are going to do with the Basel capital standards," says Davis. Over time, he added, QRM might be absorbed into the Basel process--or simply fall out.

CFPB addressed QRM in its QM final regulation and has its own view of the need for QRM. "The qualified mortgage and QRM definitions are distinct and relate to different parts of the Dodd-Frank Act with different purposes, but both are designed to address problems that had arisen in the mortgage origination process," the agency states in the QM rule's preamble. "The qualified mortgage standard provides creditors with a presumption of compliance with the requirement ... to assess a consumer's ability to repay a residential mortgage loan. The purpose of these provisions is to ensure that consumers are offered and receive residential mortgage loans on terms that reasonably reflect their ability to repay the loans ... The QRM credit risk retention requirement was meant to incentivize creditors to make more responsible loans because they need to keep some skin in the game."

And this: "...while the Bureau's qualified mortgage definition will set the outer boundary of a QRM, the QRM agencies have discretion under the Dodd-Frank Act to define QRMs in a way that is stricter than the qualified mortgage definition."

Up to Congress?

Davis points out that the agencies are obliged under Dodd-Frank to devise the risk retention rule and the QRM. Given how matters have changed, the necessity may no longer be there but the law remains.

"It may be something that's revisited in this Congress," says Davis.

Davis adds: "We already have close to 350 members of the House and Senate on record, objecting to key parts of the rules--principally the 20% down payment requirement. My sense is that if there is a reevaluation, both QM and QRM will get attention."

Here's what constitutes "attention."

Davis believes QM and the ability to repay standard will receive oversight, to make sure the regulation isn't overly restrictive in effect.

"As for QRM, there may be a reevaluation of the need for it, in light of what QM will do," says Davis. "As I said, QRM is first and foremost a capital rule. It might even wind up embedded in whatever version of Basel III we wind up with."

Dealing with the avalanche

Banks hoping for any kind of temporary reprieve from the slew of regulations pending saw little cause for hope in the CFPB's QM announcement, which discussed lenders' desire for more time, or, at least, a graduated approach to implementation, rather than a massive amount of compliance expected by January 2014.

On this, CFPB stated:

"The Bureau recognizes that many of the new provisions will require creditors to make changes to automated systems and, further, that most administrators of large systems are reluctant to make too many changes to their systems at once. At the same time, however, the Bureau notes that the Dodd-Frank Act established virtually all of these changes to institutions' compliance responsibilities, and contemplated that they be implemented in a relatively short period of time. ... the extent of interaction among many of the [rulemakings] necessitates that many of their provisions take effect together."

And the Bureau added:

"Finally, notwithstanding commenters' expressed concerns for cumulative burden, the Bureau expects that creditors actually may realize some efficiencies from adapting their systems for compliance with multiple new, closely related requirements at once, especially if given sufficient overall time to do so. Accordingly, the Bureau is requiring that, as a general matter, creditors and other affected persons begin complying with the final rules on January 10, 2014.

So, keep your hardware store's number handy. You may need spare parts when the time comes to bolt all this together in your own shop.