MEMORANDUM September 17, 2020

To: Meeting Participants

From: Kara M. Ward

Re: Summary of the August 19th Qualified Mortgage Roundtable

The Qualified Mortgage Rule Background: A Primer

In 2010, the *Dodd-Frank Wall Street Reform Act* made substantial changes to the existing law known as the *Truth In Lending Act* (TILA). No change was more important to homeowners and aspiring homeowners than the new rules that ensured predatory mortgage lending would be outlawed. These rules became known as the "Ability to Repay" (ATR) rules and they now apply to every mortgage originated in the United States.

When mortgage lenders make a loan, they must adhere to the eight fundamental principles of the ATR rules which require them to consider eight underwriting factors:

(1) current or reasonably expected income or assets;
(2) current employment status;
(3) the monthly payment on the covered transaction;
(4) the monthly payment on any simultaneous loan;
(5) the monthly payment for mortgage-related obligations;
(6) current debt obligations, alimony, and child support;
(7) the monthly "debt-to-income" (DTI) ratio or residual income; and
(8) credit history.

Under the ATR, the CFPB is given authority to offer guidance on what loans meet the eight factor criteria above and to elaborate on how to meet them. The resulting set of rules are known as the "qualified mortgage" (QM) rules.

Loans that meet the criteria for a QM loan are entitled to a presumption that the lender making the loan satisfied the ATR requirements. This presumption is incredibly important to lenders in today's market. Without it, lenders have said they would increase the cost of the loan to accommodate for the potential legal liability by anywhere from 50 to 500 basis points for otherwise creditworthy borrowers in affordable loan products.

From 2013 to today, the general underwriting criteria for QM loans has required that monthly payments be calculated based on the highest payment that will apply in the first five years of the loan and that the consumer have a total DTI ratio that is less than or equal to 43 percent. The appendices to the rule go on to define "debt" and "income." The CFPB also created a temporary provision that would allow the loans GSEs would be willing to purchase the ability to be called a QM loan. Shorthand for this criteria is known as the "GSE Patch."

When lenders are found to violate ATR and not to have originated a QM loan (without regard to being a safe harbor or rebuttable presumption loan) the consumer is eligible for damages equal to all financing charges and fees, and such failure by the lender can be used as a defense in foreclosure proceedings.

Today, the CFPB is proposing to eliminate the 43 percent DTI threshold in favor of relying on a rate spread approach that determines the relative legal protections afforded to consumers. Loans that are 150 bps above the average rate offered on a typical loan will be granted "safe harbor" status so long as they meet the eight ATR principles of good underwriting and the lender obeys their own underwriting and documentation standards.

The "GSE Patch" is allowed to sunset and "Adjustable Rate Mortgages" (ARMs) will be treated separately. The proposal is available here.

What Changes and What Stays the Same?

CHANGE	STAYS THE SAME	NOTES
43% DTI is eliminated, with its attendant Appendix Q		Definitions of "income" and "assets" no longer exists
GSE Patch is eliminated		Only as of the date of the implementation of the new QM rule.
	All 8 underwriting factors of the ATR test	
	3% cap on points and fees	Industry is requesting an extension of cure periods due to sunset
	Product features of a QM: fully amortizing (no negative amortization, IO, Balloons), maximum 30–year term,	
	FHA, VA, USDA and GNMA rules	These underwriting rules may become "specific verification" standards by the CFPB
	Balloon–payment portfolio loans under QM for small rural lenders	
	No minimum downpayment	Investor guidelines and the GSEs still generally require 3% down and anything less than 20% will require credit enhancement (PMI)
	The QRM rule	
APOR + 150 bps*		Continues to be the safe harbor- proposed as the sole QM test

APOR + 200 bps		Continues to be the "rebuttable presumption" threshold
	APOR calculation	Continues to be set by the FFIEC guidance, generally the prevailing rate for a 30-year fixed rate loan with at least a 20% downpayment.
	APR and "basis points" definitions	The components of the APR as inclusive of all costs, including GSE guarantee fees, are unchanged.
"Consider"		These are the new, flexible underwriting criteria lenders use. They rely on the 8 factors above.
"Verify"		These are the new, flexible documentation standards. The CFPB is considering specifying compliant standards to aid lenders with compliance.

*APOR is "Average Prime Offer Rate".

The QM Roundtable Discussion Summary:

On August 19th, Affordable Homeownership Coalition members convened to hear some of the emerging perspectives on the newly proposed QM Rule. No consensus was sought or reached on the elements of the QM Rule that were discussed. Instead, the discussion relayed information and created an opportunity for further elaboration and questions.

- The agenda for the meeting can be found in Appendix 1.
- A list of the participants can be found in Appendix 2.
- The presentation materials used in the APOR + 200 bps discussion can be found in Appendix 3.
- A taped recording of the entire proceeding is available [here].

Item 1: Consideration of the Rate Spread Thresholds: Is 150 bps enough "headroom"?

Overview of Discussion: Presenter Lindsey Johnson, Executive Director of USMI, presented the information put together by the trade group that argued in favor of raising the proposed threshold for "safe harbor" loans from 150 bps to 200 bps. The written material that Ms. Johnson shared is available as Appendix 3 in its entirety. It is only summarized here.

1. USMI's arguments in favor of raising the safe harbor threshold can be summarized as:

(1) If APOR + 150 bps were the standard in place today, more borrowers of color and borrowers of modest means would be excluded from the pricing advantages of a "safe harbor" loan.

- A key assumption underlying this argument is that safe harbor loans bear the lowest risk of loss to investors and therefore can be offered at the best price for the consumer.
- FHA's QM standard is APOR + 115bps + MIP, which often exceeds 200 bps. If the proposal for the CFPB standard remained unchanged, borrowers would have fewer

options for loans and more limited access. Taxpayer liability and subsidized lending would increase.
- The APOR + 150/200 bps is inclusive of GSE guarantee fees and private mortgage insurance fees, both of which are subject to the review and oversight of the Director of the Federal Housing Finance Agency (FHFA). They can be adjusted to reflect non-credit risk related expenses unrelated to a borrower's individual circumstances.

(2) APOR + 150bps is an antiquated threshold from the pre-Dodd Frank era that is not anchored to today's market realities.
- APOR + 150 bps was a simple, diagnostic tool to distinguish affordable loans from predatory loans during the 2008 financial crisis - such as yield spread premiums. A simple way to make distinctions was necessary when the paperwork was in disarray. With the implementation of the Dodd-Frank reforms, the underlying features that resulted in the predatory loans are now illegal, such as excessive fees that would push the cost of a loan higher and higher above the average rate.
- Today's borrower comes to the first-time homebuyer market with higher levels of debt and less informative credit histories. Traditional underwriting relies on down payments, debt loads and credit histories- which may not be as indicative of ATR as they had been in the 1990s. Today's QM is relying on DTI and creating a pricing dynamic that does not reflect the way today's first-time homebuyers are making and spending their money.

(3) Consumers are not harmed by the loss of the rebuttable presumption protections because lenders simply do not take the legal risk and do not underwrite those loans.
- According to 2019 HMDA data, only about 4% of loans were considered "rebuttable presumption" loans - indicating an unwillingness of lenders to expand credit into those buckets where the uncertainty of legal liability increases the price of the loan.

Here are the highlights of the discussion on the move from 150 to 200 bps:

- Delegated underwriting by the FHA, combined with the assumability of FHA loans and now this QM policy may result in "steering" to FHA and away from the GSE market.
- Generally, industry participants have supported the move to 200 bps.
- Data reflected in the presentation highlights the borrowers who would be "boxed out" in the 150bps-200 bps difference are primarily people of color.
- While the FHA may still be available, on paper, for borrowers who are between 150 bps to 200 bps, it more likely they would be subject to manual underwriting. Manual underwriting is less available.
- Money and liquidity are likely to follow the safe harbor.

<u>Item 2: "Consider" and "Verify": What are the embedded lending and consumer implications of moving away from defined underwriting requirements?</u>

Overview of the Discussion: Moderator, Kara Ward, Partner, Holland & Knight LLP started the discussion with a brief summary of the proposal's key points and questions under the "consider" and "verify" umbrella. Her brief introduction is summarized below. From there, Presenter Suzanne Garwood, Executive Director and Assistant General Counsel, JPMorgan Chase walked the group through the questions and implications of moving to a "reasonable man" standard for documentation requirements under the QM rule. Presenters Chrissi Johnson, Ted Tozer and Gerron Levi presented on concepts embedded in the proposed rule on the "consider" prong of the QM analysis.

1. Summary of the "Consider" and "Verify" Prongs:

Moderator Kara Ward, Partner, Holland & Knight LLP, summarized the current CFPB proposal to eliminate DTI as the threshold for the QM analysis, turns the current industry reliance on underwriting criteria around defining "debt" and "income" prescriptively, to a more principles-based test according to the 8 ATR criteria.

2. Overview of the "Verify" Prong: Suzanne Garwood, JP Morgan:

Suzanne Garwood:

- The proposal eliminates Appendix Q and replaces the concept with "consider" and "verify". "Verify" will be discussed here, while Chrissy will discuss "consider".
- As defined in the current regulation:
    - "Verification" means that lenders are verifying current or reasonably expected income or assets, other than the value of the dwelling that is going to secure the loan, using third-party records that provide reasonably reliable evidence of the consumer's income or assets.
    - "Reasonably reliable third party records", which is the most important concept in verification, means that you can no longer rely on borrower representations, alone. This requirement persists in the new proposal.
- This proposal will allow lenders to rely on their own records about the consumer.
    - Reliance on their own records will enable lenders to be more innovative and efficient because consumers do not need to bring a dumptruck of documents to verify income and assets.
- The ATR provisions were updated in the proposal's commentary to talk about income verification.
    - Creditors must consider "unidentified funds" as income. Lenders want to be able to use deposits coming in as a reliable record for income.
- Verification of employment, and what is not verification:
    - Verification: Currently, for ATR, one must affirmatively verify employment (if it is the source of funds for repayment of the loan), but this is not required by the CFPB in their proposal.
    - Not Verification: *6th Cir. Elliott Case*
        - The bank did not meet its requirements to underwrite and test the ATR. The bank relied on a separation agreement (verbal representations about unfinalized documents) and certain leases.
- Cures
    - There is a "cure" for the 3% cap on points and fees. This cure will sunset at the same time as the GSE patch.

  - The concept of cures ought to be expanded for instances where a document is missing in a loan file when it is sold into the secondary market.

3. Summary of the "Consider" Prongs: Chrissi Johnson, Quicken; Ted Tozer, Milken Institute; Gerron Levi, NCRC.

Chrissi Johnson:

- In APOR + 200bps, we arrive at a place where we are:
  - Maintaining all product requirements.
  - Eliminating the DTI threshold.
  - Removing Appendix Q and using existing statutory language in asset and income verification. It is paper-centric.
- Creditors must consider 8 areas of a borrower's financial capacity.
- We will not be ignoring underwriting requirements or completely disregard DTI according to empirically derived standards. It is retained in the 8 points of ATR.
- Official commentary referenced in the TILA Section on QM underwriting states:
  - Lenders must ensure that a consumer demonstrated an actual ATR for a significant period of time after consummation.
  - To do this, "creditors must use an underwriting standard that has historically resulted in comparatively low rates of delinquency and default during adverse economic conditions".

Ted Tozer:

- This change is going to force more loans to go to the GSEs, because most investors are going to view the GSEs as a firewall. This will mean fewer loans go to PLS or non-QM lending.
- PLS investors today say that lenders are on the "hook" for violating investor guidelines. The determination of whether a loan has QM status or not will be thrown back to the lender in the future under this QM proposal, just as it is today. If you can rep and warrant it has QM status, then it should get QM status without much more diligence.
- The 150 bps is based on 1994 technology. Why not take machine learning to weigh factors to understand the likelihood of default? Fannie and Freddie are already using AI, it is not DTI based underwriting.
- We should push CFPB for a process to replace manual underwriting with machine learning automation. The CFPB will have to do back-testing to ensure that their algorithm results in a risk of default less than 10% or 5%, but that should determine QM status.
- APOR measures expected loss, not expectation of default. This is where LTV plays a more heavily weighted factor in the analysis. LTV is not a borrower-specific measure of their financial capacity.

Gerron Levy:

- The advocate community does not have a singular view on the QM approach, except to say that a 43% DTI does not work.
- Some advocates support raising the DTI and permitting more residual underwriting, others are broadly supportive of the rate spread approach, with some adjustments.

- NCRC has supported the rate spread approach because it seemingly increases access to credit to modest means individuals.
- It is important to emphasize that all other fair lending laws have status and enforcement in addition to ATR.

Here are the highlights of the discussion that followed on the new "Consider" and "Verify" Proposals:

- Will there be an opportunity for the kind of residual underwriting that allows a lender to underwrite based on the fact that a borrower's rent currently exceeds the monthly loan amount for which they would qualify?
    - The respondents generally agreed that there is hypothetically room for that consumer to gain access to credit. It allowed Ms. Garwood of JPM to reiterate that there is still a significant effort for lenders to carefully manage their risk- such as not agreeing to buy loans that are based on one month of bank statements.
- Will the prices continue to go up and up and exclude the working poor?
    - Ted Tozer pointed out that the FHA channel will grow under this proposal. They have no cost of capital, but also investors that want some degree of certainty in the underwriting and no credit risk.
- Is PLS doomed? Will there be QM loans in the private loan space? Will there be too many underwriting standards that eliminate the fungibility of the security?
    - Ted Tozer shared that investors will just rep and warrant to lenders, which likely increases costs so much that they cannot compete with the GSEs. If anything comes through, it will be extremely low risk loans.
- Should the CFPB be in the business of approving underwriting standards?
    - Ted Tozer suggested that it is impractical based on too many permutations on compensating factors. What makes more sense? Measuring outcomes and the likelihood of default.