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September 17, 2013

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Rulemaking Dictating Loan Terms Is Coalescing Around the CFPB's Qualified Mortgage Standard, but the Future of Loans Outside of This Standard Remains in Question

By: Laurence E. Platt, Stanley V. Ragalevsky and Sean P. Mahoney

Since the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act")[1] government regulation has been pushing the mortgage banking industry toward homogenized residential mortgage loans with characteristics that the government considers "safe." While this sounds simple enough, it has become complicated with at least three rulemaking processes dictating potentially different standards for residential mortgage loans:

- the "qualified mortgage" or "QM" definition in the Ability-to-Repay and Qualified Mortgage Standards rule (the "ATR Rule") promulgated by the Consumer Financial Protection Bureau ("CFPB") under Section 129C of the Truth in Lending Act;
- the "qualified residential mortgage" or "QRM" definition under the securitization risk retention rules (the "Risk Retention Reproposal") reproposed by a consortium of regulatory and housing agencies[2] under Section 941 of the Dodd-Frank Act; and
- the revised bank capital rules promulgated by bank regulators[3] in accordance with Basel III (the "Basel III Rules").

With the release of the Risk Retention Reproposal on August 28, 2013, a clearer picture on the interplay among these three standards is starting to emerge. The good news is that QM and QRM likely will be substantially identical. The Basel III Rules abandoned a similar concept that would have required greater capital for non-QM loans. The bad news is that implementation of QM and QRM standards will leave banks in the difficult position of having to weigh the potential adverse consequences of finding innovative but prudent ways of making credit available to those who do not qualify for standardized loan products, against potential adverse consequences under fair lending laws for not making credit available to borrowers across the socioeconomic spectrum. Before discussing the interplay among these three rules, it is worth summarizing each.

The Qualified Mortgage Standard

The Dodd-Frank Act mandated that, for a residential mortgage, a creditor must make a reasonable and good faith determination based on verified and documented information that a consumer has a reasonable ability to repay an owner-occupied, residential mortgage loan according to its terms. The ATR Rule provided a series of factors to be considered when making a determination about a borrower's ability to repay. It also provided a conclusive presumption, or safe harbor against litigation, for QM loans that are not higher-priced loans, and a rebuttable presumption of a borrower's ability to repay QM loans that are higher-priced loans.

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Broadly defined, a QM loan has the following requirements:

- no negative amortization
- no interest-only payments
- no balloon payments
- no terms in excess of thirty years
- verification and documentation of the borrower's financial resources
- points and fees must be less than three percent of the principal amount of the loan (but certain bona fide discount points excluded from this calculation in certain cases)
- monthly payments, for purposes of calculations used in determining QM status, based on the highest payment in first five years
- total debt to income ratio cannot exceed 43%, except in the case of loans meeting certain government affordability or other standards (e.g., loans meeting Fannie Mae or Freddie Mac requirements, or loans that are eligible for government insurance or guarantees)

For a more detailed discussion of the ATR Rule, please see our alert entitled, "Was Chicken Little an Optimist?" (May 23, 2013).

Qualified Residential Mortgage Loans

Section 941 of the Dodd-Frank Act directed the Agencies to adopt regulations requiring "securitizers" to retain a portion of the risk associated with securitized assets. This has popularly been referred to as a "skin in the game" requirement intended to align the interests of those originating or aggregating loans, with the interests of investors in securitizations of those loans. The Dodd-Frank Act also contemplated an exception from risk retention for "qualified residential mortgages." The Agencies first issued a proposed rulemaking under Section 941 of the Dodd-Frank Act on April 14, 2011 then issued the Risk Retention Reproposal on August 20, 2013 rather than final rules.[4]

The definition of "qualified residential mortgage" under Section 941 of the Dodd-Frank Act can be no broader than the definition of "qualified mortgage" under Section 129C of the Truth in Lending Act. In order to simplify compliance, the Agencies now propose to define "qualified residential mortgage" by cross-referencing to the definition of "qualified mortgage" under Section 129C of the Truth in Lending Act and regulations promulgated thereunder. Excluded from "qualified residential mortgage," however, are loans that are either not subject to the ATR Rule or excluded from the definition of QM, such as home equity lines of credit, loans secured by time shares, bridge loans with a term of twelve (12) months or less, loan modifications (other than those included in 12 C.F.R. § 1026.20(a)), and loans made by community based programs, down-payment assistance providers, certain non-profit organizations and housing agencies. Loans that qualify as QM loans under certain small lender portfolio loan exemptions in the ATR Rule would also be excluded from "qualified residential mortgage" to the extent that such loans must be held in portfolio for a period of time to qualify as a QM loan.

The approach taken in the Risk Retention Reproposal has the advantage of ensuring that the terms "qualified residential mortgage" and "qualified mortgage" generally would always be aligned, avoiding the possibility of a change in one definition without a change in the other. While the point

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has been made that the two terms serve different purposes – one is to protect investors in structured products while the other is to protect borrowers – these purposes are served with a common strategy of ensuring that loans are properly underwritten and that borrowers have the wherewithal to repay.

The Risk Retention Reproposal would impose potential put-back obligations on the person who organizes or initiates a securitization of QRM loans (i.e., the sponsor), even though the sponsor would not otherwise be required to retain risk. If a non-QRM loan is inadvertently placed in the pool, the sponsor would be required to repurchase such loan within sixty (60) days of discovery of the related facts. In addition, the person that aggregates and then transfers or sells QRM loans to a securitization vehicle (i.e., the depositor)[5] would be required to certify that it evaluated the effectiveness of its internal controls related to loan selection used to ensure the qualification of QRM loans. This approach addresses compliance with the QRM exception, and also provides a cure mechanism for those situations in which non-QRM loans are included in a QRM securitization pool.

The Risk Retention Reproposal also requests comment on a "QM-plus" concept which would define "qualified residential mortgage" as a "qualified mortgage" but also include an added requirement that the loan have a loan-to-value ratio of less than seventy percent (70%). In addition, a QM-plus loan would need to be secured by a first lien mortgage on a one-to-four family dwelling that serves as the primary residence of the borrower. Purchase money loans where there is more than one lien created in the transaction (e.g., "piggy-back" loans) would not qualify as QM-plus loans. Credit history would be taken into account and a loan would not be a QM-plus loan if the borrower: (a) is more than thirty (30) days past due on any obligation at the time of a cut-off date; (b) had been more than sixty (60) days past due on any obligation during the twenty-four (24) month period prior to a cut-off date; or (c) had been a debtor in a bankruptcy proceeding, had suffered a judgment to collect a debt, had personal property repossessed, had a one-to-four family property foreclosed upon or engaged in a short sale or deed in lieu of foreclosure during the thirty-six (36) month period prior to a cut-off date.

For non-QRM loans, a sponsor or depositor of a securitization will be required to retain a five percent (5%) exposure to the securitization through a "horizontal slice" (i.e., a first loss position), a "vertical slice" (i.e., a proportional exposure to each of the tranches of the securitization), or any combination of the two. The Risk Retention Reproposal also allows for reduced risk retention for securitizations consisting of blended pools of QRM loans and non-QRM loans. Importantly, risk retention cannot be pushed to an originator, unless an originator originates twenty percent (20%) or more of the unpaid principal balance of loans in the securitization and certain other conditions are met. The retained risk exposure could not be transferred or hedged for seven (7) years (or five (5) years if the aggregate outstanding principal balance of the securitization is reduced to twenty-five percent (25%) of the original aggregate principal balance). In a similar vein, risk retention is not required for securitizations consisting entirely of seasoned residential loans that have been outstanding for more than seven (7) years (or five (5) years if the aggregate outstanding principal balance is twenty-five percent (25%) or less of the original aggregate principal balance).

Treatment of Residential Mortgage Loans under Basel III Capital Rules

The final Basel III Rules were adopted by the United States bank regulators in July 2013. These rules retain the current risk weights for mortgage loans in the standardized approach, abandoning a

complicated formula that was originally proposed. Given the interagency nature of the rulemaking, the rules apply to all FDIC-insured institutions in the United States, as well as bank holding companies (other than small bank holding companies) and all thrift holding companies.

Regulatory capital requirements are designed to ensure that banks retain a sufficient cushion to absorb losses during times of economic stress. Capital adequacy is measured utilizing both risk weighted measures and a leverage measure. Risk-weighted measures consist of a ratio of capital components (i.e., tier 1 capital, tier 2 capital, etc.) to risk-weighted assets. Low risk assets such as government securities generally require little or no capital cushion, but assets that present greater risk require a larger capital cushion. The risk weighting of assets is the mechanism by which regulators both determine the amount of capital required for specific types of assets and indirectly influence the type of activities in which banks elect to engage.

Since the implementation of the Basel II Capital Accord in 2006, two sets of risk-based capital rules have effectively governed the U.S. banking industry: the standardized approach and advanced approaches. The standardized approach is used by most banks with risk-based capital ratios determined by assigning risk weights for assets based upon regulatory criteria. Banks with more than $250 billion in assets, however, are permitted to use advanced approaches, which measure risk-based capital using regulatory formulas that incorporate inputs determined in accordance with a bank's internal ratings-based system. As mandated by the Dodd-Frank Act, banks that utilize advanced approaches will also be subject to the standardized approach insofar as the standardized approach will set the floor on the total amount of capital required at such banks.

One of the more controversial aspects of the capital rules proposed by bank regulators in 2012 was the capital treatment of residential mortgage loan exposures. The bank regulators had proposed a matrix with risk weights for residential mortgage loan exposures that increased with loan-to-value ratios, and doubled or almost tripled based upon whether the loan did or did not have characteristics similar to those included in QM and QRM. Thus, under the proposal, banks would have been required to hold materially greater capital for loans that did not qualify for QM or QRM treatment, thereby creating disincentives to lend outside of the narrow QM/QRM box. This approach has been abandoned.

The Basel III Rules retain the current fifty percent (50%) risk weighting for first-lien residential mortgage loans, and a one hundred percent (100%) risk weighting for all other residential mortgage loans under the standardized approach. To qualify for the fifty percent (50%) risk weighting, a loan may not be more than ninety (90) days past due, may not be restructured or modified, and must be underwritten in accordance with prudent underwriting standards established by the bank regulators that specify, among other things, loan-to-value ratios. For purposes of determining risk weighting, loans that are modified pursuant to the HAMP are not considered restructured or modified. Where the same lender holds both a first-priority lien and junior liens with no intervening liens, the lender must treat the senior and junior loans as a single credit exposure.

The Basel III Rules also retain the current capital treatment of mortgage loans insured or guaranteed by the U.S. government or an agency of the U.S. government. Loans that are unconditionally guaranteed would retain a risk weighting of zero, while loans that are conditionally guaranteed will retain a risk weighting of twenty percent (20%).

The Basel III Rules change the treatment of securitization exposures, but structures are treated as securitizations only when there are multiple tranches. For large institutions that are subject to the market risk rule, the supervisory formula approach or simplified supervisory formula approach is used. For all other institutions, a gross-up approach is applied using the following four parameters:

the pro rata share, the exposure amount, the enhanced amount, and the weighted average risk weighting of the underlying assets.

The maximum risk weighting for a securitization exposure is 1250%, which is tantamount to a deduction from capital. A first-loss position held as retained risk would likely equal or approach this maximum. Thus, for a securitization consisting entirely of mortgages that would qualify for the 50% risk weighting, a securitization with retained risk could actually require greater amounts of capital than if the whole loans were held in portfolio. By way of example, if a bank held $100 in first-lien residential mortgage loans with a risk weighting of 50%, it would need to hold $4 in capital to maintain a risk-weighted capital ratio of 8% (50% x $100 x 8%). If those same loans were securitized and the bank held a horizontal slice of 5%, in a first loss position at a risk weighting of 1250%, the bank would need to hold $5 in capital (5% x $100 x 1250% x 8%).[6] To state the obvious, the interplay between the Basel III Rules and the form of risk retention (whether imposed by the market or regulations promulgated under Section 941 of the Dodd-Frank Act) will need to be taken into account in securitizations.

While the capital rules will not change the treatment of loans held in portfolio, they may make securitizations of non-QRM loans more capital intensive when risk is retained as a horizontal slice. The proposed rules had raised the possibility that portfolio lending would become more capital intensive and that banks would need to develop new systems to track additional mortgage loan data points in order to calculate capital requirements. Retaining the current risk weighting of residential mortgage loans will not ameliorate the impact of QM or QRM, but we suspect that portfolio lenders will appreciate that the Basel III Rules do not create an additional impediment to portfolio lending.

Witches' Brew of Regulatory Impacts for Non-QM Loans

While lenders can take some comfort in the consistency between QM and QRM, it is anyone's guess as to what non-QM/non-QRM lending will look like as lenders will need to consider the impact of ability-to-repay and risk retention in lieu of taking advantage of safe harbors and exemptions.

In the ATR Rule, the CFPB has provided guidance as to what a lender should consider in determining the borrower's ability to repay. But without the safe harbor, the lender bears the burden of proving that the borrower had the ability to repay the loan, potentially for the life of the loan. For higher-priced QM loans, for which only a rebuttable presumption of ability to repay is available, lenders will bear the same risk of having to prove the borrower's ability to repay at some point in the future. This risk alone may quiet the secondary market for non-QM loans and higher-priced QM loans.

Risk retention requirements may also remove motivation to securitize non-QRM loans as the capital required to be held against a retained piece may be greater in many cases than the capital that would be required to be held against those loans if held in portfolio. It remains to be seen whether a vibrant private securitization market in non-QM/non-QRM loans will develop in the midst of these challenges as well as uncertainty surrounding government sponsored entity reform.

One distinct possibility is that the market will coalesce around QM and QRM loans, with a very limited volume of loans falling outside the QM criteria. This will make it increasingly difficult for banks to be able to lend to borrowers who cannot meet the criteria, creating yet new challenges for fair lending compliance.

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[1] Pub. L. No. 111-203, 124 Stat. 1376 (2010).
[2] The agencies involved (the "Agencies") are: the Board of Governors of the Federal Reserve System (the "FRB"), the Federal Deposit Insurance Corporation (the "FDIC"), the Office of the Comptroller of the Currency (the "OCC"), the Securities and Exchange Commission (the "SEC"), the U.S. Department of Housing and Urban Development ("HUD") and the Federal Housing Finance Agency ("FHFA"). HUD and FHFA participated in the rulemaking only with respect to provisions governing residential mortgage loan securitizations.
[3] The bank regulators involved are the FRB, FDIC and the OCC.
[4] As a proposed regulation, the Agencies are soliciting comment on the Risk Retention Reproposal.
[5] If there is no such person, the sponsor of the securitization is deemed to be the depositor.
[6] For residential mortgage loans with a 100% risk weighting, or in circumstances in which risk is retained through a vertical slice or combination of horizontal and vertical slice, the capital held against retained risk exposure may be less than the capital that would be required to be held against the whole loans.

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