Economic Analysis Statement

Qualified Mortgage Definition for
HUD Insured or Guaranteed Single Family Mortgages

24 CFR Parts 201, 203, 1005, and 1007

[Docket No. FR-5701-P-01]

Summary of Analysis

The Consumer Financial Protection Bureau (CFPB) was charged under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) to establish rules ensuring borrowers have a reasonable ability to repay their mortgage loans. Loans that are considered qualified mortgage (QM) loans are those that are assumed to meet the ability-to-repay criteria, either through a safe harbor or rebuttable presumption.

Specifically, Section 1412 of the Dodd-Frank Act adds section 129C(b) of TILA, which (1) establishes the presumption that the ability to repay requirements of section 129C(a) are satisfied if a mortgage is a "qualified mortgage," (2) the criteria for a "qualified mortgage", (3) authorizes CFPB to prescribe regulations for a "qualified mortgage", and (4) directs the Department of Housing and Urban Development, or HUD, (as well as 3 other Federal agencies) to prescribe rules to define a "qualified mortgage" with regard to mortgages insured, guaranteed, or administered by HUD.

The CFPB published its final rule entitled "Ability-to-Repay and Qualified Mortgage Standards under the Truth and Lending Act (Regulation Z)," in the Federal Register on January 30, 2013, at 78 FR 6408. Prior to publication in the Federal Register, the CFPB, on January 10, 2013, posted its final rule on its website, and the posted final rule established an effective date of January 10, 2104. Accordingly, the definition of "qualified mortgage" as provided in the January 30, 2013, final rule (or January 10, 2013, posted rule) will apply to all HUD mortgages until HUD prescribes its own QM rule. The CFPB final rule temporarily grants "qualified mortgage" status to loans that satisfy the underwriting requirements of, and are therefore eligible to be insured by, HUD. This temporary QM status will expire at the earlier of (1) HUD publishing its own QM rule, or (2) seven years from the effective date of the CFPB's QM rule, which as noted above is January 10, 2014.

The expected impact of the rule is no greater than an annual reduction of lenders' legal costs of $41.0 million on the high end to $12.3 million on the low end, and may even fall below this range.

Background

The statutory charge to CFPB to issue regulations defining "qualified mortgage" results from the finding that, 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 and 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. Accordingly, the Dodd-Frank Act 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 repay the loan according to its terms. Congress also established a presumption of compliance for a certain category of mortgages, called ‘‘qualified mortgages.’’ (See preamble to CFPB’s published January 30, 2013, rule at 78 FR 6408.)

The CFPB’s QM rule creates three categories of loans: non-QM, safe harbor QM, and rebuttable presumption QM.

The Dodd-Frank Act provides that “qualified mortgages” are entitled to a presumption that the creditor making the loan satisfied the law’s “ability-to-repay” requirements. Consumers who believe that they entered into a mortgage transaction for which the creditor did not adequately determine their ability to repay the mortgage may enter into a legal challenge of the mortgage, particularly if faced with the prospect of a foreclosure due to non-repayment. However, the burden of proof on the consumer to challenge the loan’s compliance will be greater if the loan is a qualified mortgage (QM) and thus is afforded a presumption of compliance (a “rebuttable presumption”), and greater still if the presumption of compliance is considered conclusive (that is, afforded a “safe harbor” status).

Of the two types of QM loans, the “safe harbor” designation gives lenders the highest level of legal protection from consumer challenges upon subsequent default or foreclosure. Safe harbor is granted to loans which are generally lower-priced loans with interest rates closer to the prime rate. They are expected to be approved for consumers with good credit histories (low credit risk). However, borrowers can still challenge their lenders in court if they feel the loan falls short of the QM parameters.

The second category of QM loans, which are afforded a rebuttable presumption of compliance with the ability to repay rule, are expected to be higher-priced loans that are typically granted to borrowers with somewhat lower credit scores (moderate credit risk). If the borrower ends up in a foreclosure situation, he or she could win an ability-to-repay lawsuit if they can prove the creditor did not determine that their residual income needed to pay living expenses after their mortgage and other debts was adequate. Creditors will have less legal protection from consumer challenge for a QM with a rebuttable presumption of compliance.

Finally, under the CFPB rule, loans which do not meet either QM standard can still be made, but creditors face the greatest legal risk of challenge with non-QM loans given the lack of presumption of compliance with the ability to repay requirements. Non-QM loans are expected to be higher priced loans that may have features historically associated with subprime loan products, and are likely to be made to consumers with the lowest acceptable credit scores (high credit risk). Many mortgage lenders may elect not to offer non-QM loans, or may price them considerably higher than QM loans.

Section 1412 of the Dodd-Frank Act, which amends section 129C of the Truth in Lending Act (TILA), describes the features of a QM, but leaves it to the CFPB, the agency responsible for oversight and enforcement of TILA, to ultimately define QM . Section 129C(b)(3)(B)(i) of TILA authorizes the CFPB to revise, add to, or subtract from the statutory criteria upon a finding that such regulations are necessary or proper to ensure that responsible, affordable mortgage credit remains available to consumers in a manner consistent with the purposes of this section, necessary and appropriate to effectuate the purposes of this section and section 129B of TILA (entitled “Residential mortgage loan origination” added by section 1402 of Dodd-Frank), to prevent circumvention or evasion thereof, or to facilitate compliance with such sections. However, TILA does not delineate whether QM loans would have a presumption of compliance that would be conclusive or that would be rebuttable. The CFPB's final rule of January 10, 2013 delineates safe harbor QMs from rebuttable presumption QMs.

According to the CFPB rule, and consistent with the statutory criteria, a QM loan must generally meet the following requirements:

- A loan must have regular periodic payments that are substantially equal over time, except for the payment changes on an ARM;
- Negative amortization is not permitted;
- Interest-only payments are not permitted;
- Balloon payments are not permitted (except for small creditors serving rural areas);
- Terms exceeding 30-years are not permitted;
- No-Doc Loans (those that verify neither income nor assets) are not permitted;
- Points and fees paid by the consumer cannot exceed 3 percent of the total loan amount; higher fees are permitted for loans under $100,000, and up to 2 bona fide discount points are exempt; and
- Loans must have a back-end debt-to-income ratio (DTI) no greater than 43 percent or be agency qualifying (that is, qualified for insurance, guarantee, or purchase by HUD/FHA (Federal Housing Administration), Department of Veterans Affairs, Rural Housing Service, or the Government-Sponsored Enterprises).

As of January 10, 2014, the CFPB QM rule will be applicable to all 1-4 unit single family home mortgage products insured by HUD except reverse mortgages. The CFPB rule provides temporary QM status to all loans that satisfy the underwriting requirements of HUD and are eligible for insurance under the National Housing Act as long as the first three elements of the general definition are met.

In addition, a QM loan will receive a safe harbor presumption of compliance if the loan is not considered a higher-priced covered transaction. For a first lien, this will be the case when the Annual Percentage Rate (APR) on the mortgage is less than 1.5 percent above the Average Prime Offer Rate (APOR)[1], a measure of the market level of mortgage interest rates. The APOR will be calculated by the CFPB, and will be very similar in spirit to the Primary Mortgage Market Survey Rate, currently produced by Freddie Mac. A higher-priced covered transaction that meets the QM requirements noted above is granted a rebuttable presumption of compliance.

Need for HUD QM Rule

Section 129C(b)(3)(B)(ii) of TILA, as added by section 1412 of the Dodd-Frank Act, requires HUD (as well as three other Federal agencies)[2], in consultation with the CFPB, to prescribe QM rules with regard to mortgages insured, guaranteed or administered by HUD that would be "qualified mortgages." Section 129C(b)(3)(B)(ii) gives HUD the same discretion that was given to the CFPB, which is to revise, add to, or

[1] This "higher-priced covered transaction" threshold is the same calculation that is in place following the HOEPA 2008 rule for a higher-priced mortgage loan. Refer to the discussion of the CFPB APR to APOR threshold in the Appendix.

[2] The three other Federal agencies are the Department of Veterans Affairs, the Departure of Agriculture, and the Rural Housing Service.

subtract from the statutory criteria upon making certain findings that the changes are consistent with 129B and 129C of TILA.

The purpose of section 129C(b)(3)(B)(ii) is to allow for loans insured, guaranteed, or administered by HUD, VA, USDA, and RHS to be governed by the agencies' definition of qualified mortgage, not CFPB's definition. The statutory charge to these four agencies to issue their own definitions of qualified mortgage for their financing programs reflects a statutory view that these agencies are in the best position to define "qualified mortgage" for their loan products, consistent with the purposes of sections 129B and 129C of TILA, and within the statutory parameters of the programs and the mission of each agency. While HUD determined that certain components of the statutory criteria, as implemented by CFPB, would work for HUD, CFPB's rule does not take into consideration (nor was it required to) the important mission of HUD's programs, the populations the HUD programs are designed to serve, and the separate statutory criteria that govern these programs. Unlike the CFPB, HUD's definition is not designed for the general lending market but for the lenders who participate in HUD's mortgage insurance and guarantee programs, and the borrowers who utilize mortgages under HUD's programs, and, as previously noted, the Dodd-Frank statute is clear that HUD's definition of "qualified mortgage" is to govern HUD programs.

By establishing a definition that aligns to the extent feasible with the statutory criteria while still adhering to the mission and statutory parameters of HUD's mortgage insurance and loan guarantee programs, HUD's programs retain their focus on the populations that they were designed to serve. Further and equally important, such a definition allows HUD's programs to retain their statutorily established role as a source of credit for underserved borrowers rather than function as a significantly different and broad alternative in competition with the conventional lending market for all borrowers.

Accordingly, HUD's rule needs to be issued and effective by January 10, 2014, to decrease the risk of disruption to HUD's mortgage programs and avoid jeopardizing the availability of an important source of affordable home financing for first-time homebuyers, minority homebuyers, including Native Americans and Native Hawaiians. If HUD's rule is not effective by this date, these mortgages will be subject to the CFPB's definition of qualified mortgage, a definition that is not focused on, to the extent that HUD's definition is required to be, the populations that the HUD programs have a mission to serve. Specifically, CFPB's definition would result in a lower share of safe harbor qualified mortgages for FHA and the lack of a HUD rule on qualified mortgages would create uncertainty among FHA lenders.

HUD's rule complies with the statutory rulemaking requirement by proposing the standards by which HUD-insured mortgages or guaranteed loans for single-family dwellings meet the definition of qualified mortgage and by which a rebuttable presumption qualified mortgage is distinguished from a safe harbor qualified mortgage. In complying with the statute, HUD used its discretion to align its definition of qualified mortgage for mortgages insured by the FHA pursuant to the National Housing Act to the CFPB's broader QM definition, except where alignment would be inconsistent with the FHA's mission. FHA's mission is to provide access to safe, affordable and sustainable homeownership opportunities for people with limited wealth, to those who are otherwise underserved by the conventional market, and to ensure the financial soundness of the FHA program.

HUD further used its discretion to define as safe harbor qualified mortgages those mortgages insured under HUD's Title I Property Improvement Loan Insurance program (Title I), authorized by section 2 of the National Housing Act (12 U.S.C. 1703), and loans for Indian housing guaranteed under section 184 of the Housing and Community Development Act of 1992 (12 U.S.C. 1715z-13a) (Section 184 guaranteed loans) and for Native Hawaiian housing under section 184A loans under the Housing and Community Development Act of 1992 (1715z-13b) (Section 184A guaranteed loans).

Note that Section 184 and Section 184A loans are not insured under the authorities of the National Housing Act, but HUD reads the reference to the National Housing Act in Section 1412 of the Dodd Frank Act as not being an exclusive, limiting provision. Such a reading would undercut the intent present in the broader language directing the several housing agencies to make qualified mortgage determinations for the types, without qualification, of the loans they insure, guarantee, or administer. HUD, therefore, interprets the more general language of this provision to permit HUD to define types of mortgages besides those insured under the National Housing Act as qualified mortgages. Therefore, HUD's proposed rule would define "qualified mortgage" for FHA-insured single family mortgages, section 184 loan guarantees and section 184A loan guarantees.

Summary of HUD's QM Rule

In promulgating its own QM rule, HUD would remove the application of CFPB's QM rule to HUD-eligible loans which otherwise meet the CFPB's product type QM requirements[3]. The principal alternative to this proposed rule is for HUD not to issue its own QM rule, which would extend the CFPB temporary exemption through January 10, 2021. This alternative is referred to as the *status quo* alternative.

HUD's QM rule adopts the same points and fees threshold as the CFPB QM rule[4] for all of its FHA single family (1- to 4-unit) mortgage products except for reverse mortgages (which are exempt from QM requirements). HUD's Title I loans, Section 184 and Section 184A loans, because of their unique features, would not be subject to the same points and fees as provided in the CFPB rule, but would be designated safe harbor QMs. All other HUD mortgages that would not meet the CFPB QM points and fees threshold (and therefore be non-QM under CFPB rules) would continue to be non-QM under the FHA rules. However, non-QM single family mortgages or loans would not be eligible to be insured by HUD.

Under HUD's QM proposed rule, any single family loan insured under the National Housing Act (NHA), except for those insured under Title I, warrants at least "rebuttable presumption QM" as long as the mortgage does not exceed the CFPB's limits on points and fees. Such loans may qualify to be "safe harbor" QM if they also do not exceed the FHA rule's limit on the APR to APOR spread.

HUD's QM rule also adopts a different limit on the APR to APOR spread: A non-Title I loan insured under the NHA that meets the HUD requirements, including the new points and fees requirement, is considered a "safe harbor QM" if the APR for the first lien covered transaction relative to the APOR is less than the combined annual mortgage insurance premium (MIP) and 115 bps.[5] Thus, the FHA QM rule recognizes that FHA serves a clientele that is riskier than the market in general and that the cost of providing mortgage insurance to this clientele is higher as well. Without such accommodation, a high

[3] The CFPB's exemption for mortgages insured by the FHA under the National Housing Act expires at the earlier of January 10, 2021 or when the FHA publishes its own QM rule for effect.

[4] See discussion of points and fees in the Appendix.

[5] As detailed in HUD's Mortgagee Letter 2013-4, the term for which HUD-insured mortgages are subject to payment of the annual MIP varies by the loan term to maturity and or other characteristics of the insured loan. Variations in the term of the annual MIP can affect the APR calculation for the loan. HUD has decided for simplicity not to vary the 115 basis-point threshold in its proposed Safe Harbor standard to account for variations in APR due to term of the MIP charge.

share of FHA loans would be considered "higher-priced covered transaction" under the status quo alternative and be rebuttable presumption QM.   HUD does not expect its loan volume to increase nor does it expect the volume of conventional loans to be materially affected by this rule, and consequently HUD's market share is not expected to increase as a result of this rule.

HUD is authorized under its Title I program to provide insurance for property improvement and manufactured home loans. Under the Title I program, HUD insures private lenders against loss on property improvement loans they make. The applicant-borrower must have a good credit history and the ability to repay the loan in regular monthly payments. Both large and small improvements can be financed, but the maximum loan amount is $25,000. The Title I program helps lower-income homeowners improve the basic livability or utility of their homes, and allow for such improvements as energy efficiency. Most Title I loans secured by a dwelling, which comprise a very small share of all single family loans insured by FHA, would not, under HUD's proposed rule, meet the CFPB's points and fees threshold. Therefore, these loans would be non-QM under the status quo alternative. HUD is providing safe harbor status to this group of loans recognizing the special role these loans play in its mission. However HUD's QM rule also notes that these loans "require further study so as to determine the additional parameters for distinguishing the rebuttable presumption and safe harbor QM".

Similarly, the Section 184 and Section 184A guaranteed loans, which HUD is authorized to make under the Housing and Community Development Act of 1992, would not, under HUD's proposed rule, be required to meet the points and fees threshold set by CFPB. Congress established the Section 184 and Section 184A loan guarantee programs because Native America and Native Hawaiians, respectively, were not being well-served by the conventional mortgage market. Because of the unique status of Indian lands being held in Trust, Native American homeownership has historically been an underserved market. Working with an expanding network of private sector and tribal partners, the Section 184 Program endeavors to increase access to capital for Native Americans and provide private funding opportunities for tribal housing agencies with the Section 184 Program. The purpose of the Section 184A loan is to provide access to sources of private mortgage financing to Native Hawaiian families who could not otherwise acquire housing financing because of the unique legal status of the Hawaiian Home Lands or as a result of a lack of access to private financial markets. These loans also would likely be considered non-QM under the status quo scenario. HUD's QM rule explicitly grants safe harbor to these loans recognizing that these loans serve a particularly underserved market.[6] HUD does not want to alter the underwriting requirements for these loans at this time, perhaps imposing a barrier to lenders serving these markets, without the opportunity for further consideration of how the statutory QM criteria would impact these loan guarantee programs.

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[6] According to the U.S. Census, American Community Survey for 2007-2011, 9 percent of occupied homes on American Indian reservations and on off-reservation trust land are overcrowded, compared to 3.1 percent of national households. Overcrowding has negative effects on a family's health, especially children's health, and tends to exacerbate domestic violence, truancy, and poor performance in school. Homes suffer more wear and tear when they are overcrowded, and the over-use of appliances coupled with poor ventilation can lead to conditions that promote mold growth. Furthermore, to focus on two states where there is a relatively large American Indian/Alaska Native population—South Dakota and Alaska—the 2010 Census clearly showed the disparity between the AI/AN population and the general population: About 15.7 percent of the "AI/AN alone" (single-race) population in South Dakota was overcrowded, compared to only 2.1 percent of the total population in that state. Likewise, in Alaska, about 17.2 percent of the "AI/AN alone" population was overcrowded, while only 6.2 percent of the total population in Alaska was overcrowded.

Economic Analysis of HUD's QM Rule

Summary

Under the status quo alternative, some loans (excluding Title I) which are currently insured by FHA would not qualify as QM based on their exceeding the points and fees limit for QM. All other loans that FHA currently insures would meet QM standards under the status quo, but about 20 percent only do so with rebuttable presumption of compliance with ability to repay. These loans would not qualify for safe harbor under the CFPB rule's 150 basis point limitation on the spread between APR and APOR -- in large part because this spread for FHA loans includes FHA's annual mortgage insurance premium (MIP) that is typically about 135 basis points in the current FHA 203(b) program. The remaining FHA loans under the status quo (about 74 percent) would qualify for QM status with safe harbor presumption of compliance with ability to repay requirements. Figure 1 illustrates the characteristics of these three categories of FHA loans under the status quo alternative.

The impacts of HUD's proposed rule are relatively small. Some HUD insured or guaranteed loans would be non-QM under the status quo due to points and fees above the QM limit. These loans would remain non-QM under the proposed rule. The difference is that HUD, through this rule, will no longer insure loans with points and fees above the CFPB level for QM. This policy provides a very strong incentive for HUD mortgagees to comply with the QM points and fees requirements. As a result, only a fraction of the 7 percent of non-QM loans (from HUD's 2012 analysis) would have to find alternatives to FHA execution, or not be made at all, once HUD's QM rule is in place. Most of the 7 percent of the non-QM loans (from HUD's 2012 analysis) are expected to comply and to continue to be insured by HUD, once the rule is in place.

The majority of HUD loans insured or guaranteed prior to the implementation of this rule will qualify as QM under both the status quo and under HUD's proposed QM rule. The main difference is that far fewer QM loans are presumed to meet the ability to repay with a rebuttable presumption of compliance under the proposed rule (1 percent rebuttable presumption) compared to status quo (20 percent rebuttable presumption). Similarly, more QM loans will be presumed to meet the ability to repay with a safe harbor presumption of compliance (93 percent safe harbor under the proposed rule compared to 74 percent safe harbor under status quo). Figure 1 also illustrates the characteristics of these loan categories for FHA-insured loans under HUD's proposed QM rule assuming that the second half of 2012 could be considered representative of the entire year.

The economic impacts for FHA loans (excluding the special loan categories discussed below) represent lower legal costs for FHA mortgagees in defending potential challenges by defaulted mortgagors on ability to repay based on the safe harbor presumption of compliance rather than rebuttable presumption. While about 19 percent of FHA's non-Title I loans would switch from rebuttable presumption to safe harbor under the proposed rule, only a small fraction of FHA loans would be subject to a challenge in the first place. Thus, the FHA QM rule would not have an economic impact above $100 million, and the rule is not economically significant.

Analysis by Loan Groups

1. Streamlined Refinances and ARMs

In a communication to mortgagees dated June 3, 2013,[7] FHA Commissioner Galante stated that, in consultation with CFPB, HUD believes that its requirements around ability to repay are sufficient to satisfy Regulation Z and the ability to repay for FHA loans that are higher priced mortgage loans (HPML) with the exception of streamlined refinances and some adjustable rate mortgages (ARMS), depending on how they are underwritten. For instance, streamlined refinances that are HPMLs and where income or assets are not verified by obtaining confirming documentation, do not meet the ability-to-repay-requirements as specified in Regulation Z. On January 10, 2014, however, these loans would meet the ability-to-repay requirements when the status quo alternative goes into effect as such loans meet HUD's underwriting requirements by definition. [8] If HUD's QM rule goes into effect at the same time period, these two categories of loans would once again meet the ability-to-repay requirements by explicit inclusion in HUD's rule. Thus the net impact of these loans on the mortgage market remains the same in both the status quo and HUD's QM scenario – that is, no impact from the proposed rule.

2. Title I loans and Sec 184/184A loans

As discussed above, under the CFPB rule, this group of loans would have been subject to the points and fees structure for all SF loans and many of these would have upfront fees and points that exceed the cap listed and would therefore be non-QM. Some of these loans would have met the upfront fee cap but might have been classified as rebuttable presumption QM only due to their APR exceeding the APOR by more than 1.5 percent. Instead, under HUD's QM rule, all these loans are considered safe harbor QM with no points and fees and APR limits. This recognizes the unique nature of these loans and provides HUD the flexibility to make programmatic changes as needed to meet the housing needs of underserved borrowers.

Between July 2012 and May 2013, FHA endorsed approximately 3,954 Title I loans with an average balance of $47,900. Between October 2012 and May 2013, HUD guaranteed 2,988 loans under Section 184/Section 184A with an average balance of $175,000. The benefits of providing safe harbor QM status to these loans is that it enables HUD to meet its mission and that without this safe harbor QM status, these loans would be non-QM. While it is not unreasonable to argue that lenders and the market in general would need additional compensation to originate or securitize non-QM loans, this particular set is either insured or guaranteed (100 percent loan guaranty in the case of Section 184/Section 184A) by a federal agency. Thus, it is hard to argue for a lack of demand in the status quo scenario. However, Ginnie Mae typically co-mingles these loans with other FHA loans in its pools. If Ginnie Mae is not permitted or chooses not to pool non-QM loans with its QM loans then it will likely have to create new pools for these loans. Apart from the cost of such operations to Ginnie Mae, it is unlikely to impose any further significant economic impact on the mortgage market. On the benefits side, assuming that all Title I, Section 184, and Section 184A are re-classified from non-QMs or rebuttable presumptions QMs to safe harbor QMs, the lender legal costs to defend loans would be lowered by a high estimate of

[7] http://portal.hud.gov/hudportal/documents/huddoc?id=FrDesCarGalaJun2013_Final.pdf.

[8] A HPML must meet certain requirements to comply with Regulation Z, including ability-to-repay requirements. Currently, the only way to meet the ability-to-repay requirement is to undergo specific underwriting requirements, including a verification of income and assets. When the status quo alternative goes into effect a HUD loan that meets HUD's underwriting requirements, as well as the first 3 requirements of the general qualified mortgage definition will be either a safe harbor qualified mortgage that meets the ability-to-repay requirements or a rebuttable presumption qualified mortgage that is presumed to have met the ability-to-repay requirements. Therefore, HUD's streamlined refinances that comply with HUD's underwriting will meet the Regulation Z requirements for HPMLs.

$1.1M or low estimate of $400,000 as indicated in Figure 2. Because HUD does not track APR or points and fees on Title 1, 184, and 184A loans, it cannot estimate with certainty the percentage of loans that would be non-QM. As such, HUD believes a high share of these loans would be non-QM, and assumes 100 percent for this analysis, but it reasonable to state that this percentage may be less than 100 percent, and the resulting benefits to consumers and legal cost reductions for lenders from the proposed rule may be overstated.

3. Other HUD loans that are non QM (non-Title I/Section 184/Section184A loans):

This category of loans does not meet the CFPB points and fees threshold and would be deemed non-QM under the status quo. If under the proposed rule, mortgagees do not voluntarily comply with the points and fees threshold then these loans would remain non-QM under HUD's QM rule, and therefore not eligible for HUD insurance., However, lenders would have a very strong incentive to reduce the points and fees to bring these loans into compliance with QM (perhaps reclassifying some as "bona fide" points and fees as permitted under the Dodd Frank Act or curtailing the process of allowing borrowers to buy down the interest rate through upfront points in order to originate an FHA insurable loan). HUD, like other agents in the current market, does not have detailed information on the points and fees charged on its loans as defined in the CFPB rule. However, HUD does have information on interest rates and loan closing costs (which may include points and fees as well as other costs which would not be subject to the points and fee limit). If all the reported closing costs were assumed to be points and fees that would apply toward the QM limit, HUD conservatively estimates (high estimate) that as many as 45,751 loans (about 7 percent of single family non-Title I loans) insured between July 2012 and May 2013, would not meet the points and fees thresholds. A vast majority of these loans could be expected to be made as lenders could be expected to find ways to comply with the QM requirement and still originate the loan with HUD insurance. However, on the margin, if the lender is not able to find ways to meet the points and fees threshold for these loans then the lender will need to find alternatives to HUD execution (such as through credit unions and rural lenders who have different limits for points and fees) for these loans. If they are unable to do so, then some loans that were made in the past with FHA insurance will no longer be made.

HUD assumes that the CFPB's points and fees limitation (which is based on statute) for the broader mortgage market is also appropriate for the FHA segment of the market. HUD is concerned that a possible deviation from the CFPB's limitation could lead to higher points and fees within FHA programs, because higher points and fees products could leave or shift from the broader market (i.e., possibly raising an adverse selection issue). HUD is, in turn, concerned that this effect would have negative implications for borrowers covered under FHA programs. However, HUD acknowledges the need for additional data on the points and fees charges for FHA loans, and the need to track and further evaluate this data within the FHA segment of the market and commits to do so.

If lenders are unable to originate say 10 percent of the non-QM loans that formerly were HUD-insured that would amount to only about 0.5 to 1.0 percent of FHA's currently endorsed portfolio that would be impacted. Borrowers who are impacted by this would likely have to defer homeownership until they are able to qualify for a loan with lower upfront fees and points. For the large majority of the non-QM loans formerly insured by HUD, the intent of the CFPB rule and HUD proposed rule is to motivate lenders toward compliance through originating qualifying loans that perform well over the long run rather than focusing on maximizing upfront fees and points at origination without regard to performance. Thus, lenders will have a strong incentive to change their behavior in the case of this group of loans.

Lenders who reduce points and fees to come into compliance are transferring a portion of their legal cost savings from obtaining qualified mortgage status to the borrowers who pay the lower charges. If HUD had proposed a limit in excess of the CFPB standard on points and fees for receiving QM status, there would be fewer borrowers benefiting as lenders would have less incentive to reduce points and fees (in both the FHA market and in the conventional market as conventional lenders who charge points and fees above the CFPB limit but below a higher HUD limit could attain QM status by sending some of these loans to HUD). Moreover, HUD through proposing its own Rebuttable Presumption standard based on the spread between APOR and APR plus MIP keeps pressure on conventional lenders to keep APR within the limit for Safe Harbor as well, which will help ensure consumers are not merely charged higher interest rates in return for reduced points and fees.

4.
5. Other QM loans not included in the exception groups above:

This other category represents the majority of FHA loans, including those insured under Title II of the NHA, and other HUD QM loans (that is, all non- Title I or Section184/Section184A). Loans that are QM under the status quo alternative in this group continue to be QM under HUD's rule. What will change is whether they are afforded presumption of compliance with rebuttable presumption or with safe harbor. There are two changes in HUD's QM APR to APOR spread calculation. First the MIP is explicitly included in the FHA rule's calculation but the limit on spread itself is reduced from 150 basis points (in CFPB rule) to 115 basis points (in FHA rule). As shown in Figure 1, the group of loans that is afforded rebuttable presumption QM will be reduced while the pool of safe harbor QM loans will be increased. HUD estimates that there were 129,500 (about 19 percent) single loans over the period with (relatively high APRs) between July 2012 and December 2012 that would have been rebuttable presumption QM under the status quo that are now safe harbor QM under HUD's QM rule.

The impact of this reclassification to the market is that by moving a sizeable group of loans (about 19 percent) from rebuttable presumption to safe harbor, lenders face lower costs of compliance under HUD's QM rule than under the status quo alternative and therefore receive incentives to continue making these loans without having to pass on their increased compliance costs to borrowers. This reclassification could also motivate lenders to reduce APR for some loans just above the 115 basis point plus MIP limit on the APR to APOR spread to obtain safe harbor status, provided the reduced APR does not result in an offsetting increase points and fees that would exceed the 3 percent limit on such charges. This could affect a portion of the remaining 1 percent of loans which would not be moved to safe harbor status by this rule. If a lender cannot come into compliance with the HUD safe harbor limit on APR to APOR spread on a loan, the lender will either choose not to make the loan, or will charge more for the higher legal risk associated with rebuttable presumption of compliance with the ability to repay. As noted in the discussion to follow, the estimated cost of this higher legal risk expressed as an increase to the note rate ranges from 3 to 10 basis points. However, the net effect on HUD volume from the modified safe harbor definition in HUD's QM rule is likely to be modest given that the reduction in costs to HUD lenders is modest as noted below.

While borrowers benefit from not having to pay for the higher lender costs, they also face less opportunity to challenge the lender with regard to ability to repay.
HUD expects that almost all borrowers will gain because the reduction of the interest rate will compensate for the loss of the option to more easily challenge a lender. In addition, with reduced interest payments, the likelihood of a challenge is reduced. Very few borrowers will lose from this rule. The reduction in legal costs represents a societal benefit. However, there may be the rare instance where this rule may prevent a settlement in the borrower's favor representing a transfer from the

borrower to lender (to be redistributed to all other borrowers). HUD submits that the likelihood of such lawsuits has been reduced greatly by changes in lending practices stemming from the Dodd-Frank Act and the lawsuits initiated by the Department of Justice, U.S. Attorneys and State Attorneys for fraudulent records of borrower information.

Lenders will likely incur some costs in changing their points and fees in order to comply with the APR and APOR spread calculation for HUD. However, these costs are likely to be a fraction of the benefits to the lender from the reduction in legal costs. With respect to estimates of legal costs, please see CFPB's preamble at 78 FR 6508-6509. Some commenters responding to the proposed rule that preceded the CFPB's final rule presented estimates of the litigation costs associated with claims alleging a violation of the ability-to-repay requirements. One commenter estimated that if claim is not disposed of on a motion to dismiss, the fees for the cost of a full trial could reach $155,000.

With respect to issues regarding transfer/cost implications for reducing the choice set for borrowers (e.g., by discouraging the purchase of interest rate-reducing points), it is possible that the choice set for borrowers may be reduced in a high interest rate environment. In the current environment of non-high interest rates, this impact is likely to be minimal.

With respect to any additional recordkeeping costs, CFPB noted, in its final rule, that any additional recordkeeping costs associated with its QM final rule will be "de minimis" since the rule merely extends the period that creditors must retain evidence from two years (under Regulation Z) to three years. HUD expects a similar impact from its rule.

To estimate the size of the reduction in cost to FHA lenders, HUD notes that the CFPB has estimated that legal costs to defend potential challenges on a non-QM loan would add between 3 and 10 basis points to the interest rate on the loan. The following is from the CFPB's RIA for its QM rule:

> *Combining liability costs and repurchase costs, estimated costs for non-qualified mortgage loans (loans made under the ability-to-repay standard without any presumption of compliance) are estimated to increase by approximately twelve basis points (or 3 basis points (0.03 percentage points) on the rate); under very conservative estimates, this figure could be as high as forty basis points (or ten basis points (0. 1 percentage points) on the rate).*[9]

An estimate of 10 basis points on the note rate on the loan provides a conservative (high) upper bound of the per-loan cost for defending potential challenges on FHA loans that are QM with rebuttable presumption of compliance. It is an upper bound because QM loans with rebuttable presumption are expected to incur much lower legal costs to defend against challenges than non-QM loans. That is, QM status provides a presumption of compliance with the ability to pay criteria of TILA, while a non-QM loan receives no such presumption. Therefore, loans qualifying as QM with rebuttable presumption should have lower legal costs to defend potential challenges than non-QM loans. Furthermore, the difference in cost for defending legal challenges on a QM loan with rebuttable presumption compared to a QM loan with safe harbor presumption will be less than the total estimated legal cost of defending the QM with rebuttable presumption loan. This follows because the cost of defending challenges on safe harbor

[9] Regulatory impact analysis by the CFPB of the "Ability-to-Repay and Qualified Mortgage Standards under Truth in Lending Act (Regulation Z)", page 24.

QM loans is expected to be much smaller than the cost for a rebuttable presumption loan, but not zero. Thus, the 10 basis point increase in mortgage rate is clearly an upper bound of the per affected loan cost of the impact of HUD's QM rule, although the lower 3 basis point increase could be considered a more reasonable estimate of the cost per loan. Based on the calculations in Figure 1 below, the total first year impact of the rule ranges from a high estimate of $41.0 million to a low estimate of $12.3 million, and could be lower.

In addition to these benefits, HUD expects that a rebuttable presumption category could place downward pressure on the APRs of FHA mortgages. This downward pressure could have positive implications for FHA borrowers. As this analysis shows, HUD finds that the greater legal protections afforded to qualified mortgages would lower legal costs and lower interest rates among FHA-approved lenders. HUD finds that under-served populations could especially benefit from these lower interest rates and undisrupted underwriting practices. While HUD finds that the legal protections and benefits are greatest for safe harbor mortgages, it declines to define all qualified mortgages as safe harbor mortgages, because it wishes to preserve the possible downward pressure on APR. In addition, HUD seeks to adopt a qualified mortgages structure similar to the CFPB.

6. Non-FHA Loans which are "Agency-Eligible"

There is a temporary provision under the status quo (that is, under CFPB's QM rules effective January 10, 2014 and extending for up to seven years) to permit certain loans with back end DTI >43 percent that are not currently executed through FHA or through the GSEs (Fannie Mae or Freddie Mac), but which are considered "agency-eligible" to be classified as QM. These loans would have regular periodic payments, have terms not exceeding 30 years and meet the CFPB QM limits on fees and points and would meet the underwriting requirements and (if within conforming loan limits) would be considered eligible for purchase, guarantee or insurance by FHA, the government-sponsored enterprises (GSEs) (while in conservatorship), the VA, USDA, or RHS. CFPB estimated that as of the year end 2011, such loans were approximately 18 percent of the market[10]. Even though complete data on points and fees and product features was lacking, the CFPB nevertheless concluded that "roughly 97 percent of these loans should qualify for the legal safe harbor with the conclusive presumption of compliance (i.e. they are not higher-priced covered transactions) and 3 percent are estimated to qualify for the rebuttable presumption (i.e. they are higher-priced covered transactions)." As the preamble notes, CFPB extended QM status to these loans under the status quo alternative in order to provide additional certainty to the "fragile" mortgage market and limit disruptions to the supply of mortgage credit with only limited effects on consumers. Note that under the status quo alternative, this pool (18 percent that are agency-eligible per CFPB's estimate) would likely be held in the lender's portfolio since these loans only have to be agency eligible but not actually delivered to the agency.

In 2011, FHA represented 11.5 percent of total mortgage market originations[11]. Applying this share to the 18 percent market segment implies that HUD's QM rule would be applicable to approximately 2 percent of the 2011 market which would now be governed by HUD's QM rule rather than the status quo. However, none of these agency-eligible loans that might come to FHA will lose QM status due to

[10] See p. 590/591 of the Preamble to the rule available at http://files.consumerfinance.gov/f/201301_cfpb_final-rule_ability-to-repay-preamble.pdf.
[11] See http://portal.hud.gov/hudportal/documents/huddoc?id=fhamktq2_2012.pdf.

HUD's QM rule. This is because the loans would remain agency eligible for other agencies, specifically for Fannie Mae or Freddie Mac while in conservatorship. Furthermore, FHA has issued Mortgagee Letter 2013-5 which would require manual underwriting (and likely require documentation of compensating factors for approval) on most loans that would comprise this 2 percent of the 2011 market thus limiting the ability of lenders to send some of these loans to FHA. Therefore the impact of the proposed rule on these loans is negligible.

Conclusion

The impacts of HUD's proposed rule are relatively small. HUD's rule in effect reclassifies a sizeable group of loans (about 19 percent) of Title II loans insured under the National Housing Act from rebuttable presumption qualified mortgages under the CFPB's rule to safe harbor qualified mortgages under HUD's proposed rule. A small number (about 7 percent) of Title II loans would continue to not qualify as qualified mortgage based on their exceeding the points and fees limit, while the remaining FHA loans (about 74 percent) would qualify for qualified mortgage status with a safe harbor presumption of compliance with the ability to repay requirements under both the CFPB's rule and HUD's proposed rule. The Title II loans that would be non-qualified mortgages under the CFPB's rule would remain non-qualified mortgage under the proposed rule. The difference is that HUD, through this rule, will no longer insure loans with points and fees above the CFPB level for qualified mortgage, but expects that most of these loans will adapt to meet the points and fees to be insured. In addition, HUD classifies all Title I, Section 184 and Section 184A insured mortgages and guaranteed loans as safe harbor qualified mortgages that would have most likely been non-qualified mortgages under the CFPB's rule. As a result of these reclassifications, lenders face lower costs of compliance under HUD's qualified mortgage rule than under the CFPB's rule and therefore receive incentives to continue making these loans without having to pass on their increased compliance costs to borrowers. While borrowers benefit from not having to pay for the higher lender costs, they also face less opportunity to challenge the lender with regard to ability to repay. Given that litigation involves many wasteful costs, HUD expects that almost all borrowers will gain from the reduction in litigation and that the reduction of the interest rate will compensate for the loss of the option to more easily challenge a lender. As a result of the reclassification of some of HUD loans, the expected impact of the rule is an annual reduction of legal costs by from \$12.3 to \$41 million, and may even fall below this range, as the range was derived from the CFPB's estimate of the range of legal cost differences between a QM loan and a non-QM loan

Based on the above, HUD has determined that its proposed QM rule is not economically significant. Additional background material is contained in the appendix.

<u>Figure 1</u>: Impact of FHA QM vs. Status Quo Alternative on FHA Loans (excluding Title I, and Streamline Refinances) Insured Between July - December 2012.

	# of Loans (Jul-Dec 12)	Share of Total Loans (#)	Share of Total Loans ($)	Average Loan Amount	Share of DTI>43	Average DTI	Av LTV	Average FICO	APOR	Interest Rate	Points and Fees
Status Quo											
Non QM	45751	7%	6%	$162,418	39.20%	39.03%	92.54%	700	3.66%	3.63%	1.25%
QM RP	134398	20%	18%	$164,822	38.71%	39.15%	94.82%	680	3.64%	3.93%	0.19%
QM SH	503040	74%	76%	$186,459	35.06%	37.64%	92.94%	701	3.63%	3.59%	0.12%
Total	683,189	100%	100%	$180,593	36.23%	38.10%	93.26%	696	3.63%	3.66%	0.21%
FHA QM											
Non QM	45,751	7%	6%	$162,418	39.20%	39.03%	92.54%	700	3.66%	3.63%	1.25%
QM RP	4,837	1%	0%	$111,886	24.90%	34.24%	88.48%	643	3.38%	4.72%	0.20%
QM SH	632,601	93%	94%	$182,433	36.06%	38.055	93.37%	696	3.63%	3.65%	0.13%
Total	683,189	100%	100%	$180,593	36.23%	38.10%	93.26%	696	3.63%	3.66%	0.21%

<u>Source: HUD data; HUD does not collect detailed information on points and fees and hence used proxy variables to estimate the points and fees on loans for this analysis (all </u>reported closing costs were assumed to be points and fees). The points and fees indicated in the table are expressed as percentage point differences in APR calculation. Note that this table is based on loans insured in the second half of 2012.

Appendix

Discussion of points and fees threshold:

The general qualified mortgage limitation set forth in TILA for points and fees is that they may not exceed 3 percent of the total loan amount. The CFPB adopted a tiered schedule based on loan size:

Loan Amount	Cap
$100,000 or more	3%
$60,000 to $99,999	$3,000
$20,000 to $59,999	5%
$12,500 to $19,999	$1,000
Less than $12,500	8%

The fixed dollar amounts in the schedule are to be indexed for inflation.

For QM purposes, points and fees include only charges payable in connection with the loan transaction, which is defined to mean that charges are included in points and fees only if they are "known at or before consummation."

Charges for a subsequent loan modification are not included because they are not known at consummation of the original loan. On the other hand, the maximum prepayment penalties that may be charged under the new loan do constitute points and fees, because they are known at consummation. Prepayment penalties, incurred if the borrower is refinancing his or her current loan with its existing holder or servicer (or an affiliate of either), are included.

All items that are included in the "finance charge" for purposes of TILA, except interest or time-price differential, are included in points and fees. Federal loan guarantee charges are excluded, as are premiums for Federal or state mortgage insurance or guarantee fees. All charges for private mortgage insurance are excluded if they are payable after consummation. Charges for private mortgage insurance payable at or before consummation also are excluded to the extent that they do not exceed the amount of FHA allowable upfront mortgage insurance premiums (i.e., the amount payable under section 203(c)(2)(A) of the National Housing Act, provided that it is required to be automatically refundable on a pro rata basis on notification that the loan has been satisfied). Charges payable at or before consummation for credit life, credit disability, credit unemployment or credit property insurance and the like are included.

Bona-fide third party charges generally are excluded from points and fees if not retained by the lender, loan arranger or any of their affiliates. Therefore, settlement charges paid to third parties are excluded, whereas settlement charges paid to affiliates of the lender are included. Points charged to offset loan level price adjustments are included in points and fees.

Up to two "bona fide discount points" may be excluded from points and fees if the pre-discount interest rate does not exceed the APOR by more than two percentage points, and up to one bona fide discount point may be excluded if the pre-discount interest rate does not exceed the APOR by more than one percentage point. A discount point is "bona fide" if it reduces the interest rate or time-price differential based on a calculation that is "consistent with established industry practices."

Under TILA, points and fees include all compensation paid directly or indirectly by a consumer or creditor to a mortgage originator from any source. This includes compensation paid to mortgage brokerage firms, individual brokers, and employees of the lender such as its loan officers. Despite extensive industry comment, the CFPB did not waive the statutory requirements as they apply to individual loan originators, such as loan officers. The CFPB did clarify that compensation must be counted towards points and fees only if can be attributable to the specific transaction at the time the interest rate is set.[12] Therefore, individual employee compensation must be included in points and fees only if it can be attributed to a particular transaction. This could result in double-counting, as loan originator compensation that is recovered through origination charges is already included in points and fees. While the Rules do not yet address this issue, the CFPB has requested additional comment on this topic and intends to determine whether to require double-counting before the Rules become effective.

Industry commenters such as the MBA have noted that concerns around the calculation of points and fees and the limit itself are amplified the smaller the size of the loan.

<u>Discussion of APR to APOR spread</u>

A loan that meets the requirements of QM above is "safe harbor QM" if it does not have an annual percentage rate (APR) 150 bps or more above the APOR for a first lien mortgage or 350 bps for a subordinate lien mortgage. [13] A loan that meets the QM requirements but has an APR that exceeds the APOR by 150 bps or more for a first lien mortgage or by 350 bps or more for a subordinate lien will be a rebuttable presumption QM.

The APOR is calculated based on the Freddie Mac Primary Mortgage Market Survey (PMMS) which includes data only on conventional loans. Moreover it has been pointed out by several commenters that typically about two –thirds of the loans surveyed by the PMMS consist of purchase money loans which typically have lower mortgage rates than refinance mortgages. Thus the PMMS could be systematically biased against refinance mortgages so that a larger portion of these could exceed the 150 bps spread. Other concerns around APOR include the concern that APOR are not accurate for loans with LTVs above 80 percent since the impact of mortgage insurance is not considered. For ARMs, the concern centers around the comparability of APOR: if the APR is calculated using a higher initial rate than the fully indexed rate, then the APOR should be calculated in the same way.

[12] On May 29, 2013, the CFPB issued an amendment to the ATR Rule clarifying what is included in the points and fees calculation. For instance, the CFPB clarified that compensation paid by creditors and mortgage brokers to their employees is excluded from the points and fees calculation preventing double counting. Similarly while consumer payments to mortgage brokers will not be double counted, an additive approach is adopted when the consumer pays the creditor and the creditor pays the mortgage broker: such compensation by the consumer or creditor to the mortgage broker is included in the points and fees calculation. Details are available at http://files.consumerfinance.gov/f/201305_cfpb_final-rule_atr-concurrent-final-rule.pdf.

[13] Note that the Federal Reserve Board's 2008 rule for "higher priced" mortgages also had the same threshold.

Many commenters including the MBA in their comment letter, have recommended that the safe harbor for all loans should be raised to 200-250 basis points over APOR to accommodate these issues with the PMMS.

Figure 2 below provides a tabular summary of the two rules.

Figure 2: CFPB QM and FHA QM rules

CFPB QM Rules

<table>
<tr><td>Non QM</td><td colspan="2">QM: Loans must have standardized features including regular periodic payments that are substantially equal (except for payment changes on an ARM), upfront points cannot be more than cap listed and loans must have back end DTI <43% or be eligible for agency execution</td></tr>
<tr><td>Negatively amortizing loans;
IO;
Loans with balloon payments (except for small credit servicers in rural areas);
Loan terms exceeding 30 years
Loans with no verification of income and no verification of assets;
Loans with back end DTI>43% and ineligible for agency execution;
Loans with high upfront fees above cap listed:
<table><tr><th>Loan Amount</th><th>Cap</th></tr><tr><td>$100,000 or more</td><td>3%</td></tr><tr><td>$60,000 to $99,999</td><td>$3,000</td></tr><tr><td>$20,000 to $59,999</td><td>5%</td></tr><tr><td>$12,500 to $19,999</td><td>$1,000</td></tr><tr><td>Less than $12,500</td><td>8%</td></tr></table></td><td>Safe harbor:
All of the above plus:
Mortgage Rate <=1.5% above APOR</td><td>Rebuttable Presumption:
All of the above plus:
Mortgage Rate >1.5% above APOR</td></tr>
</table>

FHA QM Rules

Rebuttable Presumption QM: Any single family mortgage insured under the National Housing Act except for HECM must be at least rebuttable presumption QM which would include CFPB's limits on points and fees. Exception: Section 184/Section 184A loan guarantees and Title I mortgages which are automatically safe harbor without any limits on upfront fees and points
Safe Harbor QM: All non-Title I FHA insured mortgages must meet the requirements of rebuttable presumption QM and have an APR for a first-lien covered transaction relative to the APOR that is less than the combined annual mortgage insurance premium and 1.15 percentage points. Title I are automatically safe harbor as are Section 18/Section184A loans.