STRUCTURED FINANCE ASSOCIATION

QM Patch Symposium

Key Takeaways

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Andrew Davidson & Co., Inc. (AD&Co) and the Structured Finance Association hosted a QM Patch Symposium on June 20th bring together policymakers, regulators, stakeholders, and market participants to discuss the QM Rule and the QM Patch which is currently set to expire in 2021

Introduction

Under Dodd-Frank, the Consumer Financial Protection Bureau (CFPB) implemented the Ability to Repay/Qualified Mortgage (ATR/QM) rule which states that mortgage lenders must make “a reasonable, good faith determination” of each borrower’s ability to repay the proposed loan. The ATR portion of the rule was designed to prevent lenders from knowingly making predatory loans the QM portion of the rule provides lenders a safe harbor from lawsuits alleging that the lender failed to verify the borrower’s ability to repay. The CFPB rule also allows any loan eligible for purchase by the GSEs to achieve QM status. This temporary exemption afforded to the GSEs, also known as the GSE QM Patch, will expire in January of 2021. A sudden expiration of the Patch without a thoughtful transition by industry participants and policymakers could have potential negative consequences for borrowers.

Faced with this pending expiration of the Patch, the Structured Finance Association and AD&Co, organized a QM Patch Symposium to bring together regulators, stakeholders, industry participants and thought leaders to discuss the QM Patch, examine the current state of the non-QM market, explore the creation of a level playing field, and ensure that creditworthy borrowers have access to credit. This was intended to be a helpful step in bringing together multiple voices and views from across primary and secondary markets as we work together to help ensure that our nation’s housing system works for the borrowers it intends to serve.

Regulator Comments

Brian Johnson (Deputy Director, CFPB) thanked meeting attendees for their participation, as well as for their engagement throughout the CFPB’s recent review of the Ability to Repay (ATR) and Qualified Mortgage (QM) rules. He noted that in looking back at the rule, the CFPB was interested in answering the following questions:

- Is Debt-to-Income (DTI) the best means of calculating a borrower’s ability to repay a loan?

- If so, how should DTI be calculated? Are there other factors in addition to or in lieu of DTI that should be used?
- How can industry participants get greater clarity on complying with the rule?
- How can the CFPB address transition issues arising from a potential move?

He noted that their goals include ensuring a level playing field, with simple, clear rules consistent with the CFPB's statutory authorities and a smooth transition.

Adolfo Marzol (Principal Deputy Director, FHFA) also stressed the importance of a level playing field with respect to Fannie Mae and Freddie Mac (GSEs). He noted that regardless of the CFPB's final determination of the QM rule, the FHFA will require the GSEs to maintain a prudent, responsible, and sustainable credit box.

Data Overview

Participants noted that in 2018, approximately $260 billion of loans flowed through the QM GSE Patch. QM Patch loans appear to outperform certain lower DTI loans, suggesting that DTI was perhaps not the best single-use variable for determining a borrower's ability to repay. It was also noted that the QM Patch currently fulfills a vital role in providing access to underserved markets, including borrowers with non-W2 earnings, younger and older borrowers, and borrowers of color.

According to CFPB analysis there was a decline in high DTI lending as a result of the implementation of the rule, especially for high balance loans. Some non-QM loan originators suggested that this was due to the initial start-up costs of non-QM lending, and that the market is currently more robust.

During this discussion, attendees noted some inherent difficulties in parsing out the impact of the rule. For instance, by using loan performance and delinquency rates as key indicators, regulators risk substituting a borrower's propensity to repay with a borrower's ability to repay. It was suggested that more data on refinances might yield a more fulsome picture of whether a borrower had the ability to repay the loan at the time it was originated. Additionally, the data indicate that in many instances, a borrower's credit score and the loan-to-value (LTV) ratio are better predictors of the loan's performance, and by extension, perhaps more indicative of that borrower's ability to repay.

Participants also noted that while we have much more data and analysis now than we did when the rule was initially promulgated, it represents a period of economic growth and house price appreciation, and that performance data over a longer time period of multiple economic cycles would yield more insights. Finally, it was noted that some firms have originated loans through the GSEs'

Automated Underwriting Systems (AUS), but then chosen to deliver those loans to the PLS market, which offers better execution in some instances than the GSEs. This allows them to achieve best execution while reducing potential legal liability through the safe harbor of the GSEs QM Patch.

GSE Perspective

Representatives from the GSEs noted that while DTI is a metric they use, it is not the only factor reflected in their AUS; in fact, it is not one of the most important factors. They believe that their ability to use compensating factors in addition to DTI allows them to extend credit to borrowers in a way that is prudent and responsible. The observation was made that it is entirely possible to responsibly underwrite a loan for a borrower with a high DTI, just as it is possible to less responsibly underwrite a loan for a borrower with a relatively low DTI.

Data shows that while delinquency rates are somewhat linked to DTI, the high DTI loans of the GSEs (above 45% DTI) have lower delinquencies than many lower DTI loans.

Numerous participants observed that underwriting is both an art and a science, and that the current rule can constrain the ability of an underwriter to do their job of balancing borrower risk against different characteristics. While many participants noted that the exclusive use of DTI for purposes of defining QM was problematic, many also believed that DTI can and should be used as one of many various factors in responsible underwriting. One participant observed that an ancillary benefit of the rule's focus on DTI is that it has increased consistency in the reporting of debt and income across PLS and GSE channels.

Housing and Community Advocates

Participants highlighted that factors like DTI, credit score, LTV are factors highly correlated with a borrower's race or ethnicity, suggesting that any changes to the QM rule may disproportionately impact borrowers of color. It was noted that borrowers of color have historically faced restricted access to credit as well as higher borrowing costs, and regulators must take steps to avoid making changes that threaten to repeat the discriminatory impact of previous policies. Moreover, it was suggested that more data from the GSEs—combined with the implementation of new technologies like artificial intelligence that could better predict a borrower's ability to repay—would help reduce the discriminatory impact of any changes to the QM rule.

Participants also highlighted the history of the ATR and QM rules. While these rules were in response to certain lending practices that had little to no consideration for the borrowers, participants observed that such rules were not designed to create a lending environment where every loan would always be repaid, as doing so would overly restrict access to credit. QM safe harbor was requested by the industry and does have the side effect of creating cliffs where loans are either QM or not. There was also an expectation that the non-QM market would be vibrant, but it has not developed that way. Some advocates sought the use of residual income rather than DTI, but that was not the direction adopted.

Loan Origination under the Patch

While the patch was intended to be temporary, it has worked to allow ATR lending. Since the implementation of the rules, lenders have created systems to originate patch loans; a sudden expiration of the patch would lead to a reduction in lending. Policymakers need to work with industry stakeholders in order to develop an alternative approach. Such an approach would require a simpler clearer definition of QM including how to document income, and methodologies to accurately count income from multiple sources. Innovation within automated underwriting systems is currently limited to the GSEs by virtue of the safe harbor afforded via the patch, providing them with an advantage relative to other channels. A good solution would create a level playing field between the GSEs and others.

Diligence and Ratings

The institution of the ATR rules has made loan diligence more complicated and more expensive since there are no clear rules for the non-QM loans. This was compounded by CFPB's initial decision to interpret the rule through enforcement. With no clear precedents and rules, "diligence has to define the undefinable", leading to increased uncertainty. On the other hand, the Appendix Q rules appear to be extremely rigid, with little understanding of how the CFPB might potentially enforce alleged deviations from Appendix Q rules. The Appendix Q rules have not evolved along with the market.

Rating agency participants indicated that they believe non-QM loans only face modest additional compliance risk for ATR challenges above that which already exists for the underlying default risk of such loans. In addition to higher diligence costs, non-QM loans may face higher financing costs due to the QRM rules which lead to greater risk retention and a difference in treatment of MI for loans in GSE CRT deals, where the GSEs guarantee the performance of MI and private label deals where there is a larger haircut for MI.

Current Issues with ATR/Appendix Q

While there is a small but vibrant non-QM market today, the overall volumes are not where some may have expected at the time the rule was implemented. The small size of the non-QM market also raises questions about whether there is sufficient capital to continue to fund mortgages that currently go to the GSEs should the Patch expire. Participants noted that the name "Non-QM" creates the impression that these borrowers are not qualified, or that non-QM is the same as subprime. Some participants suggested that changing the name may help change the perception around these loans, which may help increase access to credit for more borrowers.

Participants also noted that Appendix Q does not directly address numerous borrower scenarios, resulting in more uncertainty for the lender and the investor. This uncertainty results in higher transaction costs in the form of manually underwritten loans, as well as compliance costs for investors who do 100% diligence review (as opposed to sampling) on all loans. Participants noted that the GSEs benefit not only from the fact that they can underwrite QM loans with DTIs greater than 43%, but that their respective AUS implicitly comply with the documentation requirements set forth in the ATR rule. There was discussion that the CFPB can continue to work with the industry now to resolve outstanding Appendix Q questions regardless of any decisions on the QM Patch in the future.

Participants also discussed the fact that because the QM rule effectively became the Qualified Residential Mortgage (QRM) rule for purposes of risk retention, the QM designation—with all of its idiosyncrasies and unintended consequences—effectively defines the parameter of risk retention in RMBS. Finally, participants noted that while there is a relatively active investor base for certain tranches of credit risk, there is a more limited investor base for the AAA risk in private securitizations. Thus, when participants talk about the amount of capital available in the event of a change to the QM rule, it is imperative that they address investor appetite across the credit spectrum for private securitization deals. More data is needed to determine just how much private capital capacity exists today, and its ability to absorb some or all of the funding that the GSEs provide today.

Proposed Solutions

Three different proposals were discussed during the symposium.

1. One proposed solution is to simply remove the DTI threshold and Appendix Q as metrics defining the parameters of QM. This proposal would retain the QM product eligibility features of the ATR/QM statute and rule to provide a bright line definition that clearly delineates between QM and non-QM. That bright line test is important when the Safe Harbor pricing trigger (APR no more than 150 basis points over APOR) is employed to create safe harbor lender protection from legal liability. The benefit of this proposal is that the lender is obligated to underwrite the loan under the ATR components of the regulation regardless, so DTI is already considered as a factor in determining ATR compliance. Further, the basic QM product features are designed to prevent the lender from circumventing the ATR underwriting requirement. Proponents of this approach

suggest that when used in conjunction with the 150 bps over APOR Safe Harbor pricing measure—which is an indication of the credit risk of the transaction—only the very lowest-risk loans would be shielded from borrower right of private action. Proponents also noted that this approach is something which could be adopted quickly and efficiently, and which could be telegraphed to market participants well in advance of the impending GSE Patch expiration. Some participants did observe that the QM product features defined in the statute and regulation represent only one part of the QM definition, and that the regulation must also dictate what qualifies as sufficient documentation.

2. Another proposal was similar in that it provided for QM safe harbor up to a certain APOR spread limit (150 basis points), but that loans with a higher spread (250-300 basis points) could still achieve QM status if they are underwritten using an underwriter's approved and validated underwriting model. Such a model would allow borrowers with higher DTIs offset by compensating factors to receive a QM loan but remove the regulatory and compliance uncertainty that currently exists in private lenders' AUS outside of the GSEs. The CFPB would be responsible for validating and approving lenders' models and ensuring that the AUS maintain standards or guardrails established by the CFPB. While the models themselves currently exist within lenders' operations, the CFPB process for approving and validating models would have to be developed over time.

3. A third proposal would be to have industry stakeholders form a consortium that creates an AUS open and accessible to all, and which would be approved and overseen/regulated by the CFPB. The consortium AUS would create a level of standardization and accessibility across the industry and could be adjusted to account for new technology or to comply with regulatory directives. The ownership structure and the oversight regime of such a consortium AUS is not yet clear, and it would take time for both its development as well as the process by which the CFPB oversees it.

Outstanding Items

In addition to the above proposals, the groups raised a few overarching questions, which regulators and policymakers should account for as they contemplate the future of the ATR and QM rule.

- Is the goal of the rule to ensure more borrowers get QM loans? Is the goal to ensure that there exists a vibrant non-QM market? Are those two goals at odds?
- What steps will regulatory agencies other than the CFPB take to ensure that any changes to QM Patch have the intended impact, and do not simply shift to the FHA market, for instance?

- How can we ensure that marginal borrower is not disproportionately a borrower of color or from underserved communities?
- How much private capital is available to fill the gap left by the GSEs if they step back? And what is the risk appetite across the credit stack for investors with different risk appetites?
- What steps can the CFPB take now to provide clarity to the existing non-QM market? Is there a term other than "Non-QM" that can help this market thrive?

The Structured Finance Association is in the process of constructing an anonymous survey to attempt to identify common ground and/or shared concerns across the industry and market stakeholders, as well as assess each stakeholder group's concerns that will help distill the topics and proposals in a way that can help drive towards a consensus recommendation. We will seek to answer the questions raised and establish a forum for the industry and our members to provide consensus feedback to regulators and policymakers. Once that survey is available, we look forward to hearing from you. In the meantime, if you have any thoughts or comments that you believe merit consideration, please let us know.

Contributors

Michael Bright SFA, CEO michael.bright@structuredfinance.org 202.524.6301	**Andrew Davidson** AD&Co, President andy@ad-co.com 212.571.4489
Kristi Leo SFA, President kristi.leo@structuredfinance.org 917.415.8999	**Sairah Burki** SFA, Head of Policy sairah.burki@structuredfinance.org 202.524.6302
Dallin Merrill SFA, Senior Vice President, MBS & CMBS Policy dallin.merrill@structuredfinance.org 202.504.6306	