Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

Barnett Sivon & Natter P.C.
ATTORNEYS at LAW
WASHINGTON, DC

Beware the QM![*]

Raymond Natter

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Much attention has been focused on the implementation of the Dodd-Frank Act, and, in particular, on the regulation that will define the characteristics of a qualified residential mortgage, or QRM. Mortgages that meet the QRM test will be exempt from the "risk retention" requirement mandated by the Dodd-Frank Act. The risk retention provision states that a securitizer, and possibly the loan originator, should retain a portion of the credit risk of a loan when the loan is sold into a securitization structure. Because the bank regulations require a hefty capital charge for retaining any amount of credit risk on loans sold to another party, the risk retention requirement could be very costly for banks and bank holding companies. Loans that meet the definition for being a QRM can be sold into a securitization without the need for any risk retention, and therefore, the scope of this definition is very important for financial institutions that want to rely on the securitization markets for funding mortgage loans.

However, while much attention is focused on the QRM, there is another provision buried in Title XIV of the Dodd-Frank Act that will likely have a much more profound effect on mortgage finance. Title XIV provides for the licensing and regulation of mortgage originators, generally defined as any person that takes a mortgage loan application, assists a consumer in obtaining or applying for a loan, or who offers or negotiates the terms of a mortgage loan. The new consumer Bureau is to prohibit mortgage originators from "steering" any consumer to a loan that the consumer does not have a reasonable ability to repay, and from "steering" any consumer to a loan that does not meet the definition of being a "qualified loan" or QM. In addition to mortgage originators, Title XIV also imposes duties on lenders. The Act states that creditors are also prohibited from making a mortgage loan unless the creditor makes a determination that the borrower has a reasonable ability to repay the loan at the time the loan is made.

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Failure to comply with these requirements would be a violation of the Truth-in-Lending Act. As a result, a mortgage originator or creditor could be subject to both administrative enforcement actions and private suits, including class actions. The Truth-in-Lending Act provides for minimum statutory damages, so even if there are no actual damages, suits can be brought to recover statutory damages. Violation of Truth-in-Lending requirements may also be raised as a defense to a foreclosure action, and there is no statute of limitations on this defense.

The Act provides a rebuttable presumption that a residential mortgage loan complies with the ability to repay test if the loan meets the QM definition. For mortgage originators, this will provide a strong incentive to only originate QM loans, to protect against allegations of steering. For creditors, a strong incentive is also established to only make QM loans in order to benefit from the rebuttable presumption that the lender has complied with the "ability to repay" standard.

After July 21, 2011, the consumer Bureau will have the responsibility to implement the QM requirement and to issue regulations defining the term, for conventional loans. The VA, FHA, Rural Housing Administration, and Department of Agriculture will have this responsibility for loans that they insure or guarantee. The statute generally provides that a QM may not have negative amortization features, a balloon payment, or points and fees in excess of 3 percent of the principal amount of the loan. The agencies are to establish a monthly debt to income standard, or alternative method to determine affordability. Other requirements apply, including a prohibition on prepayment penalties three years after the loan is made.

The definition of a QM is separate and distinct from the definition of a QRM, except that the QRM cannot be more flexible than the QM.

As a practical matter it is unlikely that very many mortgages will be originated in the United States that are not QM mortgages. The potential liability posed to both mortgage originators and mortgage lenders for making a loan that does not qualify as a QM are quite high. Anyone making such a non-QM mortgage would likely charge a penalty rate to offset the potential liability resulting from such action. Further, it is also likely that the banking regulators will look askance at regulated institutions that make more than an exceptional non-QM loan.

So, while much attention is directed at the QRM rulemaking, it is important not to lose sight of the fact that the definition of a QM loan will probably govern the type of mortgage made in the future. There likely be no residential mortgage loans to securitize that do not meet the QM test. As a result, no matter what the QRM looks like, the QM definition will have a far more significant impact on mortgage finance going forward.

It is important to recognize this fact when debating the definition of the QRM. Any term or condition that is included in the QRM may find its way in the QM regulation. For political and other reasons, the consumer Bureau may feel that it must provide at least as much protection to consumers as the QRM is providing to investors in mortgage-backed securities. This potential should be borne in mind during the current debate on the definition of the QRM.

Raymond Natter is a partner with the law firm of Barnett Sivon & Natter, P.C.