INFOBYTES SPECIAL ALERT: HUD ADOPTS ITS OWN QM RULE

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On December 11, 2013, the Department of Housing and Urban Development ("HUD") issued a final rule defining what constitutes a "qualified mortgage" ("QM") for purposes of loans insured by the Federal Housing Administration ("FHA").[1] With limited clarifications and adjustments, the rule tracks the proposal issued by HUD in September. This final rule, which applies to all case numbers assigned on or after January 10, 2014,[2] replaces the temporary QM definition for FHA loans established by the Consumer Financial Protection Bureau ("CFPB" or "Bureau") in its Ability-to-Repay/Qualified Mortgage Rule ("ATR/QM Rule").[3]

Loans that qualify as QMs provide lenders with some legal protection against borrower lawsuits under the Truth in Lending Act ("TILA") alleging the lender did not sufficiently consider the borrower's ability to repay the loan. Under HUD's final rule, most FHA loans will qualify for the QM safe harbor if they have Annual Percentage Rates ("APRs") that are no more than 2.5 percentage points over the Average Prime Offer Rate ("APOR") for a comparable transaction (as opposed 1.5 percentage points over APOR in the CFPB's ATR/QM Rule).

The CFPB's temporary QM definition will continue to apply to loans that are eligible to be guaranteed or insured by the Department of Veterans Affairs and the Department of Agriculture until those agencies establish their own QM definitions.[4] Similarly, the CFPB's temporary QM definition will continue to apply to loans that are eligible to be purchased or guaranteed by Fannie Mae, Freddie Mac, or any successor entity for as long as those entities remain under the conservatorship or receivership of the Federal Housing Finance Authority or until January 10, 2021, whichever is earlier.[5]

BACKGROUND

Recent increases in FHA mortgage insurance premium ("MIP") costs created pressure for HUD to act quickly to replace the CFPB's QM definition for FHA loans with its own in advance of the January 10, 2014 effective date for the CFPB rule. Under the CFPB's ATR/QM Rule, lenders who make first-lien QMs with an APR that exceeds the APOR for a comparable transaction by less than 1.5 percentage points receive "safe harbor" protection from liability. In contrast, loans above that threshold (which are often referred to as "higher-priced mortgage loans" or "HPMLs") receive a less-protective rebuttable

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1 Department of Housing and Urban Development, *Qualified Mortgage Definition for HUD Insured and Guaranteed Single Family Mortgages*, 78 Fed. Reg. 75215 (Dec. 11, 2013) [hereinafter "*Final Rule Release*"].

2 *Final Rule Release*, 78 Fed. Reg. at 75231. Note that this effectiveness provision is slightly different than that for the CFPB's ATR / QM Rule, which applies to "transactions for which the creditor receive[s] an application on or after" January 10, 2014. CFPB, Final Rule, *Ability-to-Repay and Qualified Mortgage Standards under the Truth in Lending Act (Regulation Z)*, 78 Fed. Reg. 6408, 6555 (Jan. 30, 2013).

3 12 C.F.R. § 1026.43(e)(4)(ii)(B) and (iii)(A). (All citations to the C.F.R. are to the C.F.R. that will be in effect on January 10, 2014.)

4 12 C.F.R. § 1026.43(e)(4)(ii)(C)-(E) and (iii)(A).

5 12 C.F.R. § 1026.43(e)(4)(ii)(A) and (iii)(B); Cmts. 43(e)(4)-2 and -3.

presumption of compliance.[6] Because mortgage insurance premiums are generally included in the APR, the recent 10 basis point increase in the FHA annual MIP and a new requirement making FHA insurance permanent when the loan-to-value exceeds 90 percent raised significant concerns that fewer FHA loans would qualify for the safe harbor liability protection under the Bureau's ATR/QM Rule, which would potentially have a "chilling effect on FHA lending."[7]

In adopting the QM definitions discussed below, HUD stated that "[t]he MIP by itself should not be the factor that determines whether a [FHA] loan is a higher-priced transaction" that is subject to the rebuttable presumption.[8] Notably, however, FHA loans that are HPMLs must still comply with other applicable TILA requirements.

HUD'S RULE

FHA loans that are exempt from the CFPB's ATR/QM Rule – such as reverse mortgages insured by HUD's Home Equity Conversion Mortgage ("HECM") program – are also exempt from HUD's rule.[9] Other than exempt loans, however, FHA will no longer insure loans that do not meet one of HUD's QM definitions.[10]

Under HUD's final rule, the following loans are safe harbor QMs regardless of their APR, MIP, or points and fees:

- Home improvement loans insured under Title I of the National Housing Act (the "NH Act");[11]
- Manufactured housing loans insured under Title I or II of the NH Act;[12] and
- Indian and Native Hawaiian housing loans guaranteed under sections 184 and 184A of the Housing and Community Development Act of 1992.[13]

All other Title II single-family FHA-insured loans are QMs, provided they satisfy the CFPB's points and fees test. However, HUD established two separate QM categories for such loans, depending on the loan's APR and MIP: one category for loans that receive safe harbor liability protection and another for loans that receive only a rebuttable presumption of compliance.[14]

Note that in order to be QMs, all of these loans must be *actually* insured (or guaranteed) by HUD. HUD rejected requests by commenters to broaden the standard to the scope adopted by the CFPB,[15] which provides that loans need only be "*eligible* to be insured, *except with regard to matters wholly unrelated to ability to repay*."[16]

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6 12 C.F.R. § 1026.43(b)(4), (e)(1).

7 *See, e.g.*, Brian Collins, HUD Starting its Own QM Rule for FHA Loans, American Banker (Mar. 1, 2013); Christina Mlynski, FHA to Establish its Own Qualified Mortgage Rule: Galante, Housing Wire (Mar. 8, 2013).

8 *Final Rule Release*, 78 Fed. Reg. at 75222.

9 24 C.F.R. § 203.19(c) (citing 12 C.F.R. § 1026.43(a)(3)),.

10 *Final Rule Release*, 78 Fed. Reg. at 75231.

11 24 C.F.R. § 201.7(a).

12 24 C.F.R. §§ 201.7(a), 203.19(b)(3)(i).

13 24 C.F.R. §§ 1005.120 and 1007.80.

14 24 C.F.R. § 203.19(b).

15 *Final Rule Release*, 78 Fed. Reg. at 75231.

16 12 C.F.R. § 1026.43(e)(4)(ii)(B) (emphasis added).

Similar to the CFPB's ATR/QM Rule, HUD's rule provides that a Title I or II FHA loan does not automatically lose QM status as a result of an indemnification demand or a resolution of a demand, even if the demand relates to whether the loan satisfied the applicable eligibility and underwriting requirements at the time of consummation. Specifically, HUD's rule provides that: "An indemnification demand or resolution of a demand that relates to whether the loan satisfied relevant eligibility and underwriting requirements at the time of consummation may result from facts that could allow a change to qualified mortgage status, but the existence of an indemnification does not per se remove qualified mortgage status."[17] HUD did not provide an example of a scenario under which a loan might be successfully defended as a QM despite resolution of an indemnification demand.[18] One example, however, would apparently be where a mortgagee resolves an indemnification demand by a settlement without agreeing with HUD's position. That mortgagee, then, would not necessarily be precluded from litigating insurability against a borrower claiming that the loan is not a QM.

Notably, none of HUD's QM standards incorporate the restriction on the debt-to-income ratio associated with loans underwritten according to the ATR/QM Rule's Appendix Q.

Points and Fees.

A Title II FHA loan that is not exempt or is not for manufactured housing must satisfy the ATR/QM Rule's "points and fees" limitations. Specifically, the loan's points and fees must not exceed 3% of the total loan amount for loans of $100,000 or more (with different thresholds applying to lower loan amounts).[19] HUD's final rule includes a statement that any changes made by the CFPB to the definition of points and fees or the points-and-fees threshold for QM status may be adopted by HUD, but only after notice and comment.[20]

Safe Harbor v. Rebuttable Presumption.

Similar to the Bureau's ATR/QM Rule, HUD provides two degrees of protection against liability for violations of the ability-to-repay requirement. However, HUD has altered the CFPB's method for determining which FHA loans receive the safe harbor and which receive a rebuttable presumption of compliance. As noted above, these modifications are intended to address industry concerns that the recent FHA MIP changes would have caused fewer FHA loans to qualify for safe harbor treatment under the Bureau's ATR/QM Rule.

Unlike the Bureau's rule, HUD's final rule does not provide safe harbor protection based on whether a loan is a HPML (*i.e.*, a loan with an APR that is 1.5 or more percentage points above the APOR for a comparable transaction). Instead, a non-exempt, non-manufactured housing Title II FHA loan that satisfies the points and fees requirement discussed above is a FHA safe harbor QM if its APR does not exceed the APOR for a comparable transaction, as of the date the interest rate is set, "by more than the combined annual mortgage insurance premium and 1.15 percentage points."[21] In contrast, a loan with an APR above that threshold receives a rebuttable presumption of compliance with the QM standard.[22]

In explaining why it adopted this threshold in place of the Bureau's HPML threshold, HUD stated that:

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17 24 C.F.R. §§ 201.7(b) and 203.19(b)(4).

18 *Final Rule Release*, 78 Fed. Reg. at 75230-31.

19 24 C.F.R. § 203.19(b)(1).

20 24 C.F.R. § 203.19(a)(3), (b)(1).

21 24 C.F.R. § 203.19(b)(3)(ii).

22 24 C.F.R. § 203.19(b)(2)(i).

> Because all FHA-insured mortgages include a MIP that may vary from time to time to address HUD's financial soundness responsibilities, including the MIP as an element of the threshold that distinguishes safe harbor from rebuttable presumption allows the threshold to ''float'' in a manner that allows HUD to fulfill its responsibilities that would not be feasible if HUD adopted a threshold based only on the amount that APR exceeds APOR. If a straight APR over APOR threshold were adopted by HUD, every time HUD would change the MIP to ensure the financial soundness of its insurance fund and reduce risk to the fund or to reflect a more positive market, HUD would also have to consider changing the threshold APR limit.[23]

In declining industry requests that the final rule make all FHA loans safe harbor QMs, HUD stated:

> In addition to the benefit of having a construct similar to the CFPB's construct, HUD expects that a rebuttable presumption category could place downward pressure on the APRs of FHA mortgages. This downward pressure would result in transfers from some FHA lenders to some FHA borrowers, and would also provide social benefits (more sustainable homeowners due to lower rates) in the aggregate. These transfers from lenders arise from legal protections they receive from achieving safe harbor rather than rebuttable presumption status under the HUD rule. Moreover, HUD, through [adopting] its own rebuttable presumption standard keeps conventional lenders from sending loans to HUD to take advantage of what would otherwise be no APR threshold and forces conventional lenders to keep APR within the limit for the CFPB's standard or HUD's standard for safe harbor.[24]

It appears that HUD intends the lender to calculate the sum of the annual MIP rate for the particular transaction and 1.15 percentage points and then determine whether the loan's APR exceeds the applicable APOR by that amount.[25] Thus:

- If APR $\leq$ (APOR + annual MIP + 1.15), the loan is a FHA safe harbor QM
- If APR > (APOR + annual MIP + 1.15), the loan is a FHA rebuttable presumption QM

For example, if the annual MIP on a FHA loan is 1.35 percentage points, then the loan's APR can be up to 2.5 percentage points over the APOR and still qualify for the safe harbor. In contrast, under the CFPB's ATR/QM Rule, the APR for a safe harbor QM loan can only be 1.5 percentage points over the APOR.

Depending on the level of private mortgage insurance versus the annual MIP for a particular loan, creditors may find that a conventional loan that does not qualify for the CFPB QM safe harbor can receive safe harbor status if underwritten as a FHA loan.

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23 *Final Rule Release*, 78 Fed. Reg. at 75222.

24 *Id*. at 75222-23.

25 Although the text of § 203.19(b) refers to the "annual mortgage insurance premium" rather than the "annual mortgage insurance premium *rate*," it appears from the final rule – and we have received informal confirmation from HUD staff – that the MIP rate (*e.g.*, 1.35) rather than the dollar amount of the MIP (*e.g.*, $1,350 on a $100,000 loan) should be used when making this calculation. In contrast, when calculating points and fees, the dollar amount of the MIP is subtracted from the finance charge. *See* 12 C.F.R. § 1026.32(b)(1)(i)(B).

In response to industry concerns that adoption of the final rule shortly before the effective date would not provide lenders with sufficient time to make adjustments to their systems, HUD stated:

> [T]his rule should allow lenders to make the same number of insured safe harbor qualified mortgages, using systems they have already been putting in place, than if HUD had taken no action. By taking the action of issuing this rule, HUD also provides an opportunity for lenders to modify their systems further on their own timetable to take full advantage of the potential increase in the number of insured safe harbor qualified mortgages allowed by this rule. HUD expects in accordance with a lender's own timetable and allocation of resources a lender will update its systems to increase the number of HUD-insured safe harbor qualified mortgages so to track any future revisions to HUD's MIP.[26]

Rebutting the Presumption of Compliance.

Unlike the CFPB's ATR/QM Rule, HUD's rule does not permit consumers to rebut the presumption of compliance by showing that they had "insufficient residual income or assets other than the value of the dwelling . . . that secures the loan with which to meet living expenses, including any recurring and material non-debt obligations of which the creditor was aware at the time of consummation."[27] Instead, under HUD's final rule, a borrower must prove either that:

- The loan exceeded the applicable points and fees limitation; or
- The lender did not make a reasonable and good faith determination of the borrower's repayment ability at the time of consummation "by failing to evaluate the [borrower's] income, credit, and assets in accordance with HUD underwriting requirements."[28]

Because, however, a loan must meet these requirements to obtain QM status in any event, it is unclear how adjudication of a challenge to a FHA rebuttable presumption QM would differ from a challenge to a FHA safe harbor QM.

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Questions regarding the matters discussed in this Alert may be directed to any of our lawyers listed below, or to any other BuckleySandler attorney with whom you have consulted in the past.

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[26] *Final Rule Release*, 78 Fed. Reg. at 75219.

[27] 12 C.F.R. § 1026.43(e)(1)(ii)(B).

[28] 24 C.F.R. § 203.19(b)(2)(ii).