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# Favorable Treatment of Mortgage Loans Under Dodd-Frank: A Comparison

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In the wake of the financial crisis, mortgage-related reforms enacted as part of the Dodd-Frank Act or established under the Basel capital process have created four different classes of residential mortgage loans that are entitled to some kind of favorable treatment. These classes are (i) "qualified mortgages" for Truth in Lending Act purposes; (ii) "qualified residential mortgages" for the purpose of the risk retention requirements in securitizations; (iii) "Category 1" mortgages for the purpose of assigning risk weights under Basel capital requirements; and (iv) mortgages underlying residential mortgage-backed securities that may qualify as "Level 2B assets" for the purpose of the "liquidity coverage ratio" (LCR). Given these different purposes, the criteria for specialized treatment vary. The result is a patchwork of requirements that substantially increase the complexity of the mortgage origination process and the secondary market.

In an effort to simplify these four sets of requirements so that lenders and secondary market participants can make informed decisions, the attached tables compare the four different approaches to favored mortgage loans on a side-by-side basis, including the types of loans and their terms that are eligible for preferred treatment and the underwriting requirements. Any given loan could qualify for special treatment under one approach but not under others. Indeed, with the exception of the rules for qualified residential mortgages, which must take into account the rules for qualified mortgages, there has been no effort to reconcile the different regimes, which are as follows:

- ***Qualified Mortgages.*** Title XIV of the Dodd-Frank Act includes a provision that requires a creditor to make a reasonable good faith determination that the borrower has the ability to repay the loan. Under rules adopted by the Consumer Financial Protection Bureau (CFPB) in January 2013, creditors are entitled to either a safe harbor or a presumption against a claim of a violation if they originate a qualified mortgage (QM), depending on the annual percentage rate (APR) for the loan. The regulations define a QM (the "ATR Rule"). Also in January 2013, the CFPB proposed exemptions from the rules. The CFPB analysis in the final rule is complex: there are three different paths to QM status.

- ***Qualified Residential Mortgages.*** Section 941 of the Dodd-Frank Act requires the securitizer of any asset securitization (including any securitization of residential mortgage loans) to retain 5% of the credit risk of the underlying pool of assets. The retention rule does not apply, however, to qualified residential mortgages (QRMs). In 2011, the primary federal financial regulatory agencies proposed criteria for a QRM; these rules have not been finalized. Section 941(b) requires that QRMs be defined no more broadly than QMs. The QRM criteria are not as comprehensive as those for QMs, but we assume that where the QRM proposal is silent, the QM rule would apply.

- ***Category 1 Mortgages.*** Drawing on capital standards developed by the Basel Committee on Banking Supervision (BCBS), the federal banking agencies proposed three sweeping sets of capital requirements in June 2012. One of the proposals, the Standardized Approach Proposal (based on the standardized approach in Basel II), contains a series of calibrated risk weights for residential mortgage loans. These calibrations are based on the loan-to-value ratio (LTV) of the loan and whether the loan is a Category 1 or a Category 2 loan.  Category 1 loans are deemed less risky than Category 2 loans, and the Category 1 loans share some of the characteristics of mortgage loans now risk-weighted at 50% that have been "prudently underwritten."  The capital charges on Category 1 loans are materially smaller than those on Category 2 loans.

- ***High Quality Liquid Assets.*** An important innovation in the Basel III capital framework is the introduction of a liquidity coverage ratio—a requirement that a banking organization maintain sufficient "high quality liquid assets" (HQLA) to satisfy all of the organization's obligations over the coming 30 calendar days. The latest version of the LCR released by the BCBS in January 2013 allows a banking organization to include a limited amount of certain residential mortgage-backed securities (RMBS) in its HQLA.  Qualifying RMBS (and other assets) are referred to as Level 2B assets.  The Level 2B eligibility requirements in the Basel standards include certain prerequisites for the mortgages in the pool that supports the securitization, plus an external credit rating of AA or better.  The federal banking agencies have committed to adopt the LCR, but section 939 of Dodd-Frank will block them from adopting the AA rating requirement.  In its place, they will have to substitute other creditworthiness factors.  One possibility is that the U.S. regulators will look to the rating agency criteria for RMBS ratings, which include the review of certain features of the individual underlying mortgage loans.  The rating agencies do not have uniform or hard-and-fast rules for evaluating the credit risk of RMBS or the underlying mortgages, but, working from informal sources, we propose some criteria that we believe would enable RMBS to qualify for Level 2B.

Attached are two tables: Table I summarizes the loan features and payment terms that distinguish mortgage loans that are eligible for favored treatment from those that are not.  Table II sets forth the underwriting criteria—"ability to repay" for QMs—that a creditor must use to qualify its loans for favorable treatment.

## I. Loan Features and Payment Terms

| | Qualified Mortgages | Qualified Residential Mortgages | Category 1 Mortgages | Level 2B RMBS |
|---|---|---|---|---|
| ***Loan Features*** | | | | |
| ***Maturity*** | | | | |
| Maximum term | • 30 years or less. | • 30 years or less. | • 30 years or less. | • 30 years or less.<br>• Adverse risk adjustment for maturities greater than 30 years. |
| ***Liens*** | | | | |
| First-lien mortgage | • Eligible for QM status. | • Required. | • Category 1 eligible. | • Eligible—if lien is on single-family detached primary residence. |
| Junior-lien mortgage | • Eligible. | • Ineligible. | • Category 1 eligible only if same bank makes first- and junior-lien loans and if terms of both loans comply with Category 1 requirements.<br>• Risk weight would depend on LTV ratio of aggregated loans to appraised value. | • Ineligible. |
| ***Purpose*** | | | | |
| Purchase-money loan | • Eligible. | • Eligible. | • Category 1 eligible. | • Eligible—if purchase of single-family, detached primary residence. |
| Construction | • Not covered by ATR Rule. | • Ineligible. | • Category 1 eligible, if house is pre-sold and other conditions are met. | • Ineligible. |

| | Qualified Mortgages | Qualified Residential Mortgages | Category 1 Mortgages | Level 2B RMBS |
|---|---|---|---|---|
| Rate and term refinancing | • Eligible. | • Eligible. | • Category 1 eligible.[1] | • Adverse risk adjustment. |
| Cash-out | • Eligible. | • Unclear, but presumably would be subject to QM restrictions. | • Category 1 eligible. | • Adverse risk adjustment. |
| HELOC | • Not covered by ATR Rule.<br>• Covered by separate HOEPA rules, which include ability-to-repay requirements. | • Not discussed, but QM rule presumably would apply. | • Category 1 eligible, if secured by a first lien. | • Adverse risk adjustment. |
| Jumbo | • Eligible. | • Not discussed, but QM rule would apply. | • Category 1 eligible. | • Eligible. |
| Loan on second house | • Eligible. | • Ineligible. | • Category 1 eligible. | • Upward risk adjustment. |
| Reverse mortgage | • Not covered by ATR Rule. | • Ineligible. | • Category 2. | • Ineligible. |
| ***Payment Terms*** | | | | |
| Regular amortization | • Required, with limited exceptions below. | • Regularly scheduled principal and interest payments required.<br>• No payment may exceed twice as much as any earlier payment. | • Category 1 requirement. | • Required. |
| Fixed rate | Two possibilities:<br>1. Eligible for <u>safe harbor</u>, if APR does not exceed average prime offer rate for a | • Eligible.<br>• Unclear whether QM conditions on APR would apply. | • Category 1 eligible.<br>• No restrictions on rate. | • Required. |

[1] For such a loan, the assignment to Category 1 or Category 2 is based on new terms and conditions, a new appraisal is required in order to use LTV ranges (see below), and, in the absence of a new appraisal, all Category 1 loans will be risk-weighted at 100% and all Category 2 loans at 200%.

| | Qualified Mortgages | Qualified Residential Mortgages | Category 1 Mortgages | Level 2B RMBS |
|---|---|---|---|---|
| | comparable transaction on day rate is set by:<br>– 1.5%, for a first-lien loan.<br>– 3.5%, for a subordinate-lien loan.<br>2. Eligible for <u>presumption</u> of compliance, but not safe harbor if APR is outside the 1.5/3.5% bounds. | | | |
| Adjustable rate | • Eligible, subject to some conditions as for fixed-rate loans.<br>• Special rules for calculating APR. | • Eligible, but rate may adjust:<br>– No more than 2% in any 12-month period.<br>– No more than 6% over the life of the loan. | • Category 1 eligible, but rate may adjust:<br>– No more than 2% in any 12-month period.<br>– No more than 6% over the life of the loan. | • Adverse risk adjustment. |
| Interest only | • Ineligible for QM status. | • Ineligible. | • Category 2. | • Ineligible. |
| Negative amortization loan | • Ineligible. | • Ineligible. | • Category 2. | • Ineligible. |
| Principal deferrable | • Ineligible. | • Ineligible. | • Category 2. | • Ineligible. |
| Interest deferrable | • Ineligible. | • Ineligible. | • Category 2 | • Ineligible. |
| Balloon payment | • Eligible, if creditor<br>– Originates at least 50% of first-lien mortgages in counties that are rural or underserved. (CFPB will publish list of rural and | • Ineligible. | • Category 2. | • Ineligible. |

| | Qualified Mortgages | Qualified Residential Mortgages | Category 1 Mortgages | Level 2B RMBS |
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| | underserved counties annually.)<br>– Holds less than $2 billion in assets.<br>– Originates no more than 500 first-lien mortgage loans annually. | | | |
| Bridge loan (12 months or less) | • Not subject to ATR Rule. | • Ineligible. | • Category 2. | • Ineligible. |
| Timeshare plan | • Not subject to ATR Rule. | • Ineligible. | • Category 2. | • Ineligible. |
| ***Payments at Closing*** | | | | |
| Points and fees | • Ceilings apply, depending on total loan amount (TLA):<br>– 3%, if TLA $100,000 or more.<br>– $3,000, if TLA less than $100,000 and $60,000 or more.<br>– 5%, if TLA $20,000 or more but less than $60,000.<br>– $1,000, if TLA $12,500 or more but less than $20,000.<br>– 8%, if TLA less than $12,500.<br>• Lender may charge 1 to 2 points in addition to 3% if bona fide. 1 versus 2 is tied to APR on loan.<br>• Definitions of points and fees are highly | • Total points and fees not to exceed 3% of total loan amount. | • No restrictions. | • Not applicable. |

| | Qualified Mortgages | Qualified Residential Mortgages | Category 1 Mortgages | Level 2B RMBS |
|---|---|---|---|---|
| | complex. | | | |
| Down payment | • No requirement | • Required: sum of<br>– Closing costs payable by borrower.<br>– 20% of the lesser of (i) estimated market value as determined by qualifying appraisal or (ii) purchase price.<br>– Difference, if a positive amount, between purchase price and estimated market value of the property as determined by a qualifying appraisal.<br>• Other conditions:<br>– Must come solely from borrower funds.<br>– Not be subject to any obligation to repay.<br>– May not have been obtained from any person or entity with an interest in the sale.<br>• Specific verification requirements for creditor. | • Not specifically required.<br>• However, because private-label mortgage insurance cannot be used to reduce LTV, creditor likely to require substantial down payment to obtain more favorable risk weight. | • Basel standard requires 80% LTV or below. |
| Prepayment penalties | • Not expressly forbidden, but certain prepayment | • Ineligible. | • Tier 2. | • Not applicable. |

| | Qualified Mortgages | Qualified Residential Mortgages | Category 1 Mortgages | Level 2B RMBS |
|---|---|---|---|---|
| | fees or penalties must be included in points and fees for purpose of limit on points and fees.<br>• Permitted for fixed-rate, qualified mortgages if<br>– Creditor has offered alternative loan without penalties.<br>– Penalties limited to certain time periods. | | | |
| ***Other Features*** | | | | |
| Recourse to borrower | • Not applicable. | • Not applicable. | • Not applicable. | • Under Basel standard, full recourse required.<br>• Note that pool with loans in states that extinguish debt after short sale or deed in lieu of foreclosure may be disqualified. |
| Assumability | • Not applicable. | • Not permitted. | • Not applicable. | • Not applicable to distinction between Level 2B and non-Level 2B. |
| Default mitigation | • Not applicable. | • Creditor required to take loss mitigation actions<br>– When estimated resulting net present value of the action exceeds estimated net present value of recovery through foreclosure.<br>– Without regard to | • Not applicable. | • Not applicable to distinction between Level 2B and non-Level 2B. |

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| | | whether action benefits particular class of investors.<br>– Taking into account borrower's ability to repay and other appropriate underwriting criteria.<br>– Within 90 days after loan becomes delinquent.<br>– Maintaining servicing compensation requirements that are consistent with the default mitigation duty.<br>– Implementing procedures to address defaults on junior-lien mortgages.<br>– In connection with securitization, disclosing mitigation procedures before sale of securities.<br>– In sale, transfer, or assignment of servicing rights, requiring purchaser, transferee, or assignee to maintain mitigation commitments. | | |

| | Qualified Mortgages | Qualified Residential Mortgages | Category 1 Mortgages | Level 2B RMBS |
|---|---|---|---|---|
| | | • Default mitigation commitments to be disclosed to borrower at or before closing. | | |
| ***Special Considerations*** | | | | |
| Loans eligible to be purchased or guaranteed by Fannie Mae or Freddie Mac | • Qualify as QM, if<br>– Regular amortizing payments.<br>– Payments are not interest-only, neg am, or balloon.<br>– Maximum 30-year maturity.<br>– Compliance with points and fees test.<br>• This method of qualification expires on earlier of Jan. 10, 2021 or exit from conservatorship. | • Not applicable. | • If actually purchased or guaranteed by Fannie or Freddie, risk-weighted at 20%—more favorably than highest quality Category 1 loan.<br>• If not purchased or guaranteed, subject to all conditions above. | • RMBS with all underlying mortgage loans actually purchased or guaranteed likely would qualify. |
| Loans eligible to be insured or guaranteed by HUD, VA, USDA, or Rural Housing Service | • Qualify as QM, if<br>– Regular amortizing payments.<br>– Payments are not interest-only, neg am, or balloon.<br>– Maximum 30-year maturity.<br>– Compliance with points and fees test.<br>• 43% DTI requirement does not apply.<br>• This method of qualification expires on earlier of Jan. 10, 2021 or issuance by any agency of its own QM | • Not applicable. | • If actually insured or guaranteed by one of these entities, risk-weighted at 0%—more favorably than highest quality Category 1 loan.<br>• If not insured or guaranteed, subject to all conditions above. | • RMBS with all underlying mortgage loans actually insured or guaranteed likely would qualify. |

| | Qualified Mortgages | Qualified Residential Mortgages | Category 1 Mortgages | Level 2B RMBS |
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| | rule. | | | |
| Balloon loans by small rural creditors | • Qualify, if conditions for balloon payments under Payment Terms above are met.<br>• Among other things, 43% DTI does not apply. | • Not applicable. | • Not applicable. | • Uncertain. |

## II. Underwriting

| | Qualified Mortgages | Qualified Residential Mortgages | Category 1 Mortgages | Level 2B RMBS |
|---|---|---|---|---|
| ***Ability to Repay*** | | | | |
| General considerations | • Factors below are all factors in QM definition. | • Rule does not discuss all factors below, but QRM could not be treated more flexibly than QM.<br>• Agencies generally will rely on HUD Handbook 4155.1, Mortgage Credit Analysis for Mortgage Insurance (as in effect Dec. 31, 2010). | • Consistent with earlier descriptions of prudential underwriting in regulatory capital rules.<br>• Greater detail. | • Not a detailed, qualitative analysis of ability to repay.<br>• Focus on FICO score, back-end DTI, and LTV. |
| Current or reasonably expected income or assets, other than the value of the real property securing the loan | • Required. | • Required. | • Required. | • Incorporated into DTI. |
| Current employment status | • Required. | • Not discussed. | • Required. | • Not clear. |
| Monthly payments | Required using assumptions:<br>• For fixed-rate loans, assume loan is repaid in substantially equal monthly payments.<br>• For adjustable-rate mortgages, payment calculated using fully indexed rate or introductory rate, whichever is higher. | • In calculating payments, must use maximum potential interest rate payments during first five years. | Required for Category 1 eligibility using assumptions:<br>• For fixed-rate loans, assume loan is repaid in substantially equal monthly payments.<br>• For adjustable-rate mortgages, maximum interest rate that may apply during first five years. | • Incorporated into DTI. |
| Monthly payment on any simultaneous loan | • Required. | • Not discussed. | • Required. | • Incorporated into DTI. |

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| Monthly payment for mortgage-related obligations | • Property taxes.<br>• Premiums and similar charges required by creditor.<br>• Fees and special assessments imposed by a condominium, cooperative, or homeowners association.<br>• Ground rent.<br>• Leasehold payments. | | • Required. | • Incorporated into DTI. |
| Current debt obligations, alimony, and child support | • Required. | • Borrower not currently 30 days or more past due, in whole or in part, on any debt obligation.<br>• Within previous 24 months, borrower has not been 60 days or more past due, in whole or in part, on any debt obligation.<br>• Within previous 36 months, borrower has not<br>– Been a debtor in a Chapter 7 proceeding.<br>– Been the subject of any federal or state judicial judgment for the collection of any unpaid debt.<br>– Had any personal property repossessed.<br>– No 1- to 4-family | • Not discussed. | • Incorporated into DTI. |

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| | | property owned by borrower has been the subject of any foreclosure, deed-in-lieu of foreclosure, or short sale.<br>• Safe harbor for verification involving use of credit reports from two national credit reporting agencies. | | |
| Monthly debt-to-income ratio | • May not exceed 43%.<br>• Not a requirement for<br>– FHA/VA/USDA/Rural Housing Service loans.<br>– Loans by small creditors in rural areas.<br>• CFPB has proposed exemption from 43% DTI for loans originated and held in portfolio by small lenders in non-rural areas.<br>– Assets of $2 billion or less.<br>– 500 or fewer first-lien mortgages originated annually. | • Monthly housing debt no more than 28% of gross income.<br>• Total monthly debt does not exceed 36% of gross income.<br>• In calculating DTI, must use maximum potential interest rate during first five years.<br>• Debt includes real estate taxes, hazard insurance, homeowners and condominium association dues, ground rent or leasehold payments. | • None specified. | • 36% cutoff.<br>• Adverse risk adjustment for higher DTI.<br>• Favorable risk adjustment for lower DTI. |
| ***Other Factors Not Part of QM Criteria*** | | | | |
| FICO score | • None specified. | • None specified. | • None specified. | • 725 or better.<br>• Credit risk analysis sometimes includes matrix, using both FICO score and LTV. |

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| | | | | – No risk adjustment for FICO of 725 and LTV of 75.<br>– FICO of 700 may receive favorable risk adjustment if LTV is 70% or below.<br>– May be difficult for RMBS backed by loan with FICO score below 700 to qualify. |
| LTV | • None specified. | • Purchase-money loan: LTV at closing not to exceed 80%.<br>• Rate and term refinancing: LTV at closing not to exceed 75%.<br>• Cash-out refinancing: LTV at closing not to exceed 70%. | • Not relevant to Category 1/Category 2 distinction, but will affect risk weighting.<br>• “Value” is lesser of actual acquisition cost or appraised value at origination or restructuring.<br>• Private-label mortgage insurance cannot be used to reduce LTV. | • Basel standard requires LTV of 80% on average for all loans in the underlying pool, measured on the date of the issuance of RMBS.<br>• Rating agencies may impose lower LTV ceiling. |
| Appraisal | • Not specifically addressed. | • To be performed not more than 90 days before closing by state-certified or -licensed appraiser that conforms to USPAP. | • Not specifically addressed but likely necessary in order to determine LTV. | • Full appraisal, including interior inspection. |
| ***Underwriting Records*** | | | | |
| Verification | • Underwriting based on “reasonably reliable” third-party records. | • In addition to detailed verification rules for particular elements of | • Income documented and verified. | • Income verification using IRS Form 4506T.<br>• Asset verification. |

| | Qualified Mortgages | Qualified Residential Mortgages | Category 1 Mortgages | Level 2B RMBS |
|---|---|---|---|---|
| | • Income or assets must be verified using third-party records that provide reasonably reliable evidence of borrower's income or assets.<br>• May verify employment status orally, if creditor prepares record of conversation.<br>• If borrower discloses debt not included in credit report, creditor need not independently verify such debt. | underwriting, application must include acknowledgment that the information provided is true and correct as of the date executed and that any intentional or negligent misrepresentation of the information may result in civil liability and/or criminal prosecution under 12 U.S.C. 1001 (false statements to the government).<br>• Review of credit reports from at least two credit reporting agencies is sufficient verification of debt obligations. | | |
| Documentation | • Full documentation. | • Full documentation. | • Full documentation for Category 1. | • Full documentation of income. |
| Record retention | • Maintain records for three years after origination that evidence compliance with ability-to-repay and prepayment penalty provisions. | • Copies of credit reports. | • Not discussed.<br>• Subject to regulator's general rules and policies. | • Not discussed.<br>• Record retention on underlying mortgage loans subject to regulator's rules and policies. |

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