Washington Policy

Top 5 Client Questions (and Answers) on the QM Rule

Highlights

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Overview

The CFPB's QM rule was released in full after market close on Thursday. The general purpose of this rule is to establish the parameters that a mortgage lender must use when establishing whether a borrower has an "ability to repay" the loan. The rule is a jaw-dropping 804 pages. As a matter of comparison, the Volcker Rule, a regulatory attempt to end proprietary trading at banks, was about 300 pages.

While we will continue to examine the rule, and we have numerous questions outstanding to regulatory and industry contacts, this document includes the top 5 questions clients have asked as well as the corresponding answers to those questions.

Top Five Questions

- How does this relate to the QRM rule? How does this fit into the alphabet soup of mortgage rules? *See page 2.*
- This will greatly limit mortgage credit availability, right? *See page 3-4.*
- We have heard that private mortgage insurance will be capped by the CFPB's cap on fees. Is that true? *See page 5.*
- Does the 3% cap hurt certain homebuilders? *See page 5.*
- When is QRM going to be finalized? *See page 6.*

Resources

The CFPB rule
The CFPB rule summary

Question #1

Question: How does this relate to the QRM rule? How does this fit into the alphabet soup of mortgage rules?

Answer: The Qualified Mortgage (QM) rule deals with a borrower's ability-to-repay a mortgage loan and the lender's legal liability for originating the loan. The Qualified Residential Mortgage (QRM) rule deals with underwriting restrictions placed on the QM loans. Securitizers who securitize non-QRM loans will be mandated to hold a 5% piece of the securitization (known as risk retention).

Takeaway: We have described the QM rule as focusing on the borrower's financial health while the QRM rule focuses on the loan's health.

Conceptual Framework of QM and QRM Interaction

All Mortgage Loans
Prime, Subprime, Alt-A, FHA, etc.

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Qualified Mortgage (QM)
· Assesses a borrower's "ability-to-repay" the loan.
· QM loans have a legal "safe harbor" and will be cheaper for lenders.
· Loans with full doc, no neg am, no IO, no balloon, no prepayment penalties, no adjustable interest rates with fixed terms <5 years, no terms over 30 years.
· Three ways to be QM: (1) borrower has back-end debt-to-income less than or equal to 43%; (2) the loan qualifies using the GSE/FHA underwriting criteria but this path to QM is limited to 7 years; (3) the originator qualifies under the rule's small-creditor exemption.

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Qualified Residential Mortgage (QRM)
· Underwriting restrictions placed on universe of QM loans.
· 5% risk retention is imposed on non-QRM securitizations.
· The original proposals included a 20% down payment requirement which we expect to be lessened to either 5% or 10%.
· Regulators are close to finalizing this rule and we expect it by the end of Q2.

Source: UNC, CFPB, NAR, FDIC, Compass Point

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Question #2

Question: This will greatly limit mortgage credit availability, right?

Answer: The QM rule does not constrict credit as much as it could have and the rule is nowhere near as burdensome as once feared.

Takeaway: The CFPB has stated that about 95% of the current mortgage origination market will be considered a QM as the rule is written. Also, it should be noted that the finalization of this rule moves the market ever closer to completing the Dodd-Frank Act's mortgage rules.

Additional Support: Most of our client conversations centered on this question of mortgage credit availability. In our view, this rule is as inclusive as anyone in the mortgage industry could have hoped for and is remarkably less burdensome than was expected throughout the rulemaking process. Our initial assessment of the rule text is that the mortgage industry fared well when compared to the initial fears that this rulemaking could have dramatically limited mortgage credit availability. Furthermore, and most importantly in our view, we can now see the light at the end of the tunnel for Dodd-Frank Act mortgage regulations.

Generally speaking, the industry wanted three things: (1) bright line standards; (2) a safe harbor for QMs; and (3) at least a year to implement the rule.

- First, we view the rule's standards for what qualifies as QM as clear. The rule itself appears to go to great lengths to define the process for assessing borrower eligibility as well as the technical components of core definitions such as the debt-to-income calculation. The amount of granular detail is why the rule is 800 pages.

- Second, the CFPB estimates that 95% of the current mortgage market would be considered a QM under the tenets of this rule. This means that 95% of the current mortgage origination market would receive the legal safe harbor.

- Third, the rule goes into effect January 10, 2014. It is, of course, necessary to take into account the fact that originating a mortgage can take months which means originators will need their systems to be in place before January 2014, but the timeline is in line with industry requests.

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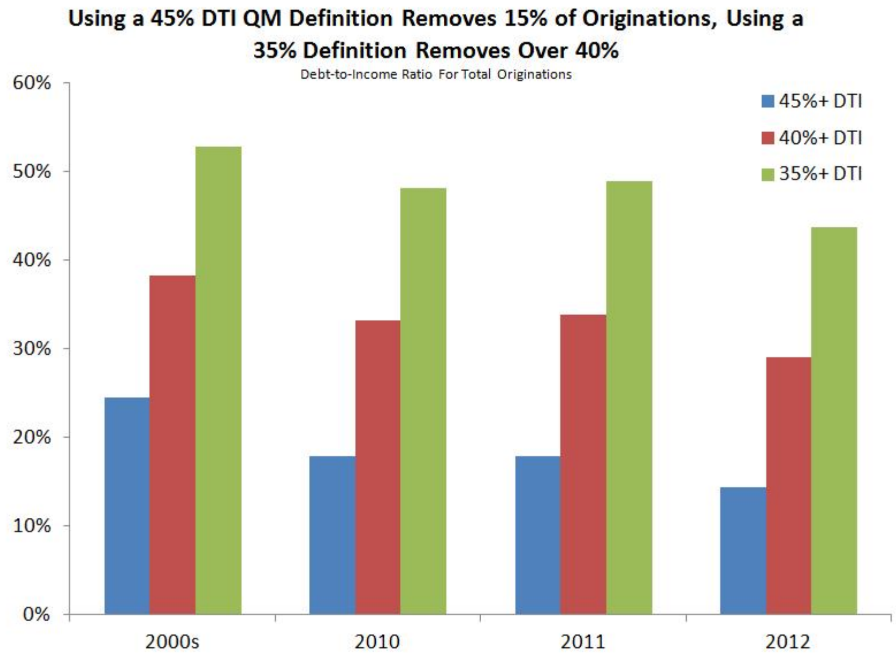
Question #2, continued

We have included below a chart provided by Corelogic which illustrates the potential impact on mortgage credit availability by using varying levels of DTI restrictions. It is important to note that this chart only reflects the DTI thresholds. The CFPB estimates that an additional ~20% of the current origination market would be a QM via the GSE/FHA exemption. The point of the chart is to show what the varying impact to mortgage credit availability could have been under more restrictive DTI thresholds.

Potential Impact of DTI Thresholds on Mortgage Originations



Source: Corelogic

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Question #3

Question: We have heard that private mortgage insurance will be capped by the CFPB's cap on fees. Is that true?

Answer: Monthly premiums do not count against the 3% points and fees cap, but there is a lack of clarity on the single premiums paid before consummation of the loan. From the rule: "For private mortgage insurance premiums payable after consummation, [law] provides that the entire amount of the premium is excluded from points and fees. For private mortgage insurance premiums payable at or before consummation, [law] provides that the portion of the premium not in excess of the amount payable under policies in effect at the time of origination under section 203(c)(2)(A) of the National Housing Act is excluded from points and fees, provided that the premium is required to be refundable on a pro-rated basis and the refund is automatically issued upon notification of the satisfaction of the underlying mortgage loan."

Takeaway: Monthly private mortgage insurance premiums were not negatively impacted by the QM rule as the premium payments after consummation are not included in the points and fees calculation. We will continue to reach out to our industry and regulatory contacts to better understand the potential impact on upfront single premiums.

Question #4

Question: Does the 3% cap hurt certain homebuilders?

Answer (provided by Compass Point homebuilder analysts Wilkes Graham and Ryan Gilbert): One concern about the QM rules is that the 3% cap on fees charged in the origination process may negatively impact the financial services revenue of homebuilders, either by capping fees or causing borrowers to originate elsewhere. The table below shows FY12 homebuilder financial services net income as a % of total EBITDA, which we believe is most relevant measure of exposure to caps on origination fees. Lennar (LEN, Neutral $33.00 PT) is most exposed on an EBITDA percentage basis to a fee cap amongst its peers. While KB Home (KBH, Sell, $10.00 PT) is the second most exposed on the list, its financial services unit does not originate mortgages so we do not believe it will be affected by QM. However, backlog conversion could decline which would delay revenue recognition if a homebuyer is diverted away from the homebuilder's in-house origination unit due to some aspect of QM. Furthermore, among the builders listed, KBH and DHI (Neutral, 18.50 PT) cater the most to first time homebuyers. The 43% DTI requirement may render ineligible first time homebuyers that would otherwise qualify for a mortgage loan. Still, we note that the GSE/FHA QM exemption will likely mitigate this issue for new homebuyers.

Takeaway: The QM rule may disincentive the one-stop-shop model that is used by some homebuilders.

FY12 Financial Services Net Income / EBITDA	
LEN	21%
KBH*	15%
PHM	14%
HOV	14%
DHI	9%
RYL	9%
SPF	6%
TOL	NA
BZH	NA

*KBH does not originate mortgages

Source: Company Filings, Compass Point

Question #5

Question: When is QRM going to be finalized?

Answer: Statements from regulators and our channel checks lead us to believe that the QRM rule will be complete in the first half of 2013. There are six different regulators responsible for the QRM rule, which has caused some disagreement along the way, but the rule is near completion. The most noteworthy element of the proposed QRM rule – the 20% down payment requirement – is likely to be lessened to either 5% or 10%.

Takeaway: The cavalcade of mortgage-related rules should be complete in the first half of 2013, removing a significant market overhang.

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