Testing for Qualified Mortgage Status

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Bankers
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A CliftonLarsonAllen LLP Division

- A consulting firm focused on helping mortgage institutions across the United States with regulatory compliance and quality control
- Provide premium file evaluation services for mortgage credit risk and compliance assessments in the area of fair lending, state, and federal regulations

About CliftonLarsonAllen

- A professional services firm with three distinct business lines
  - Accounting and Consulting
  - Outsourcing
  - Wealth Advisory
- 3,600 employees
- Offices coast to coast
- Serve more than 1,100 financial institutions

Speaker Introductions

- **Marissa Aquila Blundell, J.D., VP**
  Marissa is a client services director with Bankers Advisory – a CliftonLarsonAllen LLP Division. She serves as a contracts administrator and customer relationship manager. Marissa develops and implements compliance training to clients and serves on the compliance committee and co-chairs the Legislative Committee for the Massachusetts Mortgage Bankers Association. She is a graduate of Skidmore College and earned her Juris Doctor at the New England School of Law.

Learning Objectives

- At the end of this session, you will be able to:
  - Understand the qualified mortgage criteria related to the consumer’s monthly payment for the transaction and total debt-to-income ratio
  - Examine the underwriting guidelines contained in Appendix Q
  - Understand the test for determining whether a qualified mortgage loan is a higher-priced transaction
  - Consider the qualified mortgage status provided to certain transactions under several special rules applicable to certain creditors and transactions

Qualified Mortgages

Compliance Testing Strategies

Dodd Frank

Ability-to-Repay Rule and Qualified Mortgages

- TILA requirement added by Dodd-Frank prohibits creditors from making a residential mortgage loan without first verifying the consumer's ability to repay the loan
- Implementation: Regulation Z, Section 43, effective on January 10, 2014
- Violations of the Ability to Repay rule carry substantial penalties
- Making a "Qualified Mortgage" (QM) gives creditor legal protections from claims

ATR and QM

Compliance with ATR rule may be achieved by originating a QM loan

Two levels of legal protection:

- Safe Harbor for QM loan that is not higher-priced
- Rebuttable Presumption of Compliance for QM that is higher-priced

Higher-priced QM:

- QM APR exceeds the APOR for a comparable transaction as of the date the interest rate is set 1.5 percentage points for first lien
  - 3.5 percentage point for subordinate liens

QM Protections

Safe Harbor

- Stop litigation in earliest stage by establishing loan's status as QM

Rebuttable Presumption

- Even after QM status is established, consumer has opportunity to rebut presumption
- IF consumer successfully rebuts the presumption of compliance, the question reverts to whether or not Creditor complied with the general ATR rule: "good faith determination based on information verified using reasonably reliable third-party records"
  - Consumer success in rebutting the presumption of compliance indicates the outcome of the underlying ATR question

QM Criteria

QMs are transactions satisfying the following six criteria:

1. Regular periodic payments that are substantially equal
2. Loan term ≤ 30 years
3. Total points and fees payable in connection with loan do not exceed established limits *(3% of total loan amount for loans ≥ $100,000)*
4. Monthly payment used for underwriting must be based on maximum interest rate applicable during first 5 years and fully amortizing periodic payments, and monthly payment for mortgage-related obligations must be considered
5. Current or reasonably expected income or assets, other than the value of the security, and the consumer's current debt obligations, alimony, and child support verified in accordance with Appendix Q
6. Ratio of consumer's total monthly debt to total monthly income is ≤ 43%

QM Criteria

Requirement #1 Regular, substantially equal, periodic payments

- Exception for effect of interest rate change after consummation on payment in the case of an adjustable or step-rate mortgage, **as long as** the adjustable or step-rate mortgage does not:
  - Result in an increase of the principal balance
  - allow the consumer to defer payment of principal, or
  - result in a balloon payment, except if permitted under rules governing balloon payment QMs made by certain creditors (1026.43(f))

Requirement #2 Loan term may not exceed 30 years

- 30 years calculated from date of first payment, not consummation

QM Criteria

Requirement #3 Limited Points & Fees

- Total points and fees payable in connection with the loan may not exceed:
  - 3% of the total loan amount *(loan amounts ≥ $100,000)*
  - $3,000 indexed for inflation *(loan amounts ≥ $60,000, but < $100,000)*
  - 5% of the total loan amount *(loan amounts ≥ $20,000 but < $60,000)*
  - $1,000 indexed for inflation *(loan amounts > $12,500 but < $20,000)*
  - 8% of the total loan amount *(loan amounts < $12,500)*

Determining Points & Fees

"Points & Fees" means the following fees or charges that are *known at or before consummation*:

<u>Six general categories listed in 1026.32(b)(1)</u>

i. Finance charges
ii. Loan originator compensation
iii. Real estate related fees
iv. Insurance premiums
v. Maximum prepayment penalty
vi. Prepayment penalty in refinance by current holder

Several cross references, exceptions, conditions, and criteria apply to the above categories of fees and charges

Determining Points & Fees

Category 1 – Finance Charges

- Finance charges under Regulation Z, Section 1026.4, are included in the total *except for the following:*
  - Interest, or time-price differential
  - Federal or state government-sponsored mortgage insurance premium
  - Private mortgage insurance (PMI) premiums payable after consummation
  - PMI upfront premium up to amount of FHA up-front MIP at origination, if refundable on prorated basis automatically upon satisfaction
  - Bona fide third-party charges not retained by institution, loan originator, or an affiliate **unless** fee is:
    - » Included under the rule for upfront PMI (excess amount)
    - » Included as Real Estate Fees under separate provision
    - » Included as insurance premium under separate provision

Determining Points & Fees

Category 1 – Finance Charges

- Finance charges under Regulation Z, Section 1026.4, are included in the total *except for the following*
  - Bona fide discount points as follows so long as the interest rate without any discount does not exceed the applicable Average Prime Offer Rate (APOR) by more than two percentage points
    - » Exclude up to two points, if the interest rate without any discount does not exceed the applicable APOR by more than 1%; or
    - » Exclude up to one discount point if the interest rate exceeds the APOR by more than 1 % but less than 2%

"Bona fide discount point": Amount equal to 1% of the loan amount paid by consumer to reduce interest rate based on a calculation consistent with established industry practices for determining amount of reduction appropriate for discount point paid by the consumer

Determining Points & Fees

Category 2 – Loan Originator Compensation

- Loan originator compensation to extent known as of date interest rate is set must be included in total points & fees
  - *Exception:* compensation paid by creditor, mortgage broker, or manufactured home retailer to an **employee loan originator** is not counted
- Include compensation paid directly by consumer to mortgage broker *unless* payment is already included in total points & fees because it is a finance charge
- Include compensation paid by creditor to mortgage broker is included *even if* consumer pays origination or other charges to creditor which are included in points & fees as finance charges, or if creditor does not receive an up-front payment from consumer to cover broker's fee, but rather recoups fee from consumer through interest rate

Determining Points & Fees

Category 3 – Real Estate Related Fees

- Real estate-related fees are excluded from the finance charge, but may need to be included in calculation of total points & fees if:
  - Fee is unreasonable
  - Institution receives direct or indirect compensation in connection with the charge
  - Fee is paid to an affiliate of the creditor

Affiliate means: any company that controls, is controlled by, or is under common control with another company, as set forth in the Bank Holding Company Act of 1956

Determining Points & Fees

Category 3 – Real Estate Related Fees

- Fees for title examination, abstract, insurance, survey
- Fees for preparing loan-related documents: deeds, mortgages, settlement documents
- Notary and credit-report fees
- Property appraisal or inspection fees performed prior to consummation, including pest-infestation or flood-hazard determinations
- Amounts paid into escrow or trustee accounts not otherwise included in the finance charge (except amounts held for future payment of taxes)

Determining Points & Fees

Category 4 – Insurance Premiums

- Include premiums or other charges payable at or before consummation for any credit life, credit disability, credit employment, or credit property insurance, or any other life, accident, health, or loss-of-income insurance for which the creditor is a beneficiary

- Include any payments directly or indirectly for any debt cancellation or suspension agreement or contract

Determining Points & Fees

<u>Category 5 – Maximum Prepayment Penalty</u>

- Include the maximum prepayment penalty that may be charged or collected under the terms of the mortgage loan.

<u>Category 6 – Prepayment Penalty in certain Refinances</u>

- Include prepayment penalty incurred by consumer refinancing with current holder of the existing loan or plan, a service acting on behalf of current holder, or an affiliate of either

Determining Points & Fees

Prepayment penalty defined:

Charge imposed for paying all or part of the transaction's principal before the date on which the principal is due, other than a waived, bona-fide third party charge that the creditor imposes if the consumer prepays all of the transaction's principal sooner than 36 months after consummation, provided however that interest charged consistent with the monthly interest accrual amortization method is not a prepayment penalty for extensions of credit insured by the FHA that are consummated before 1/21/15

Determining Points & Fees

Charges paid by parties other than the consumer

- Points & fees may include charges paid by third parties in addition to charges paid by the consumer
  - Charges otherwise included as points and fees based on the rules covering finance charges, compensation, real-estate related fees, and premiums, paid by third parties must be counted towards the points & fees limit
- Examples
  - Third-party payment of a creditor-imposed fee for an appraisal performed by an employee of the creditor is included

Determining Points & Fees Threshold

"Loan Amount" determines threshold *(not the "Total Loan Amount")*

Total points and fees payable in connection with the loan may not exceed:

- 3% of the total loan amount *(loan amounts ≥ $100,000)*
- $3,000 indexed for inflation *(loan amounts ≥ $60,000, but < $100,000)*
- 5% of the total loan amount *(loan amounts ≥ $20,000 but < $60,000)*
- $1,000 indexed for inflation *(loan amounts > $12,500 but < $20,000)*
- 8% of the total loan amount *(loan amounts < $12,500)*

Compare the total points & fees with applicable limit

Determining “Total Loan Amount”

Total Loan Amount = “Amount Financed” – *certain creditor-financed “points & fees”*

- Total Loan Amount is calculated the same way for both QM and HOEPA coverage threshold
- Amount Financed under 1026.18(b)
- *IF* a charge is counted toward *“total points & fees”,* falls in one of the following three categories, and is creditor-financed, that amount must be subtracted from the Amount Financed in order to determine the “Total Loan Amount”
  - Real-estate related fees
  - Premiums for any credit life, disability, unemployment…
  - Total prepayment penalty if refinance of loan held by creditor or affiliate

QM Criteria

Requirement #4 Maximum Interest Rate and Mortgage-related Obligations

Underwriting must utilize the following:

- Monthly payment for principal and interest calculated using the ***maximum interest rate*** that may apply during the first five years after the date on which the first regular periodic payment will be due
- Periodic payments of principal and interest that will repay either the loan amount over the loan term, or the outstanding principal balance over the remaining term
- Monthly payment for any mortgage-related obligations

QM Criteria

Requirement #4 Maximum Interest Rate *continued*

- Fixed-rate mortgages use interest rate in effect at consummation
- Adjustable rate mortgages
  - Assume interest rate increases after consummation as rapidly as possible, taking into account the terms of the legal obligation
  - Apply adjustment caps as applicable
- Five years after date first regular periodic payment is due
- Example: initial fixed interest rate of 5% for 60 months, after which the rate will adjust annually to a specified index plus a margin of 6% subject to a 2% annual interest rate adjustment cap
  - Underwrite using a monthly payment of principal and interest based on 7%

QM Criteria

Requirement #5 Verification of consumers income, assets, and debt obligations

Consumer's current or reasonably expected income or assets, other than the value of the security, and the consumer's current debt obligations, alimony, and child support must be verified using **Appendix Q** guidelines

Requirement #6 Total monthly debt to total monthly income ratio must be ≤ 43%

Ratio of total monthly debt to total monthly income is ≤ 43% calculated in accordance with the standards in **Appendix Q,** and using the consumer's monthly payment on the covered transaction, including mortgage-related obligations and any simultaneous loan

Appendix Q

Effective Income

Income must be stable, verifiable, and continuing to be "effective"

- Verification of employment history
  - Most recent two full years with any gaps of 1 or more months explained
- Analysis of consumer's employment record
  - Examine past employment record and confirm current, ongoing employment status
- Creditors may *assume* employment is "ongoing" if current employment verification does not indicate employment is set to be terminated
  - Extended absences explained

Appendix Q

Forms of Income – Analysis

Analyze income for each consumer obligated for mortgage debt to determine whether income level can be reasonably expected to continue through at least the first three years of the mortgage loan

Overtime and Bonus Income

- Overtime and/or Bonus income may be used to qualify received for past two years and likely to continue
  - Develop average of bonus or overtime income for past 2years
  - If < 2 years document reason for use in writing
  - Establish earning trend and if continual decline, document in writing a sound rationalization for use; if significant variation between two years, period must be extended for average

Appendix Q

Self-employment Income

- Consumer with an ownership interest in a business ≥ 25%
- Self-employment history of two years or more
- For history less than two years, income may only be considered stable and effective as follows:
  - At least two years of previous successful employment in same line of work as self-employment, or in related occupation
  - Combination one year of self-employment and formal education or training in same line of work or related occupation
- Income from self-employment for less than one year is not effective

Appendix Q

Documentation requirements for self-employed consumers

- Individual tax returns, with all applicable tax schedules for the most recent two years *(signed and dated)*
- Federal business income tax returns for the last two years, with all applicable tax schedules for a corporation, S-Corp, or partnership *(signed)*
- Year to date profit and loss (P&L) statement and balance sheet

Establishment of earnings trend for self-employed consumers

- Use quarterly tax filings for previous two years or P&L
- If current year P&L considerably greater than previous two year's tax returns, creditor must base income solely on the income verified through the tax returns

Financial strength of self-employed consumer's business

- Annual earnings which are stable or increasing are acceptable, while business that show a significant decline over the analysis period are not acceptable

Appendix Q

Non-Employment Related Consumer Income

Alimony, Child Support, and Maintenance ***<u>Income</u>*** ***(remember ECOA!)***

- Income is "effective" if the following criteria are satisfied:
  - Income is likely to be received consistently for the first 3 years of the mortgage
  - Income is documented by either copy of final divorce decree; legal separation agreement; or court order; or voluntary payment agreement
  - Receipt of payments during the past 12 months verified and documented by acceptable evidence (*< 12 months may be acceptable if adequately document the payer's ability and willingness to make payments)* : "acceptable evidence" includes: cancelled checks, deposit slips, tax returns, court records
- Child Support may be "grossed-up" under same provisions as non-taxable income

Appendix Q

Non-Employment Related Consumer Income

Eligible Investment Properties

- Calculate income or loss by subtracting the monthly payment for Principal, Interest, Taxes, Insurance (PITI) from monthly net rental income of subject property
- Income may be added to Consumer's income
- Loss must be considered a monthly obligation

Appendix Q

Non-Employment Related Consumer Income

Rental Income

- Stability of Rental Income
  - Current lease
  - Agreement to lease
  - 24-month rental history free of unexplained gaps > than 3 months

Rental Income from Property Being Vacated by Consumer

- Rental income from a principal residence that is being vacated in favor of another principal residence may not be considered, except for
  - Relocations
  - Sufficient Equity in Vacated Property LTV of 75% or less

Appendix Q

Non-Taxable and Projected Income

Income not federally taxed may be increased by amount of continuing tax savings

- Percentage of non-taxable income that may be added cannot exceed the appropriate tax rate for the income amount
  - For consumers not required to file federal tax use tax rate of 25%

Projected Income generally not acceptable for qualifying purposes

- Exceptions exist for cost-of-living, performance raise, bonus if verified in writing by employer and scheduled to begin within 60 days of closing

- Projected income for new job acceptable if starting within 60 days of closing pursuant to contract, and creditor verifies sufficient income or cash reserves to support mortgage payment between closing and start of employment

Appendix Q

Consumer Liabilities: Recurring Obligations

- Installment loans
- Revolving charge accounts
- Real-estate loans
- Alimony
- Child Support
- Other continuing obligations

Appendix Q

Computing Debt to Income Ratio for Recurring Obligations

Include:

- Monthly housing expense
- Recurring charges extending ten months or more:
  - Installment account payments
  - Revolving accounts (even if it appears balance will be paid off within ten months)
  - Child support or separate maintenance payments
  - Alimony

- Debts less than ten months must be included if the amount of the debt affects the consumer's ability to pay the mortgage during the months immediately after closing

Appendix Q

Consumer Debt Obligations: Contingent Liabilities

Contingent liability

- Exists if individual is responsible for payment of debt if another party, jointly or severally obligated, defaults
- Exception for contingent liabilities if conclusive evidence from debt holder that there is no possibility that the debt holder will pursue debt collection should other party default
- Mortgage assumptions
- Cosigned obligations for car loan, student loan, mortgage, or any other obligation must be included unless:
  - Documented proof that primary obligor has been making regular payments during the previous 12 months
  - Documented proof that primary obligor does not have a history or delinquent payments on the loan during that time

QM Special Rules

Eligible Loan QM

- Loans eligible to be purchased or guaranteed by Fannie/Freddie while under conservatorship or receivership of FHFA, or loans eligible to be insured by HUD; guaranteed by VA; guaranteed by USDA; or insured by RHS
  - Sunsets at the earlier of: effective date of a rule issued by each agency or January 10, 2021

Repurchase and indemnification demands not necessarily dispositive of QM status

- Whether a particular loan satisfied QM eligibility criteria at consummation may be uncovered in course of dealing over a particular demand
  - Assume QC determines reported income of $50,000 was not documented and DU would not render Approve/eligible if accurate income figure of $35,000 was used
  - Loan was never a QM

QM Special Rules

Balloon-payment QM

Option for small creditor operating in rural or underserved area

- Temporary option (until January 10, 2016) for small creditors which are NOT in rural/underserved areas

Requirements for Balloon-payment QMs

- Transaction must not have negative amortization or total points and fees that exceed the limits applicable to QMs and must meet the following criteria:
- Fixed interest rate and periodic payments (other than the balloon payment) that would fully amortize the loan over 30 years or less
- Term of five years or longer
- Loan must not be subject to a forward commitment

QM Special Rules

Small-creditor QM

Criteria

- Underwrite using fully-amortizing schedule and maximum rate-permitted during the first five years after the date of the first payment
- Loan may not be subject to a forward commitment
- Income or assets, and debts, alimony, and child support must be considered and verified
- DTI or residual income must be considered, but no specific threshold established

Prohibited Features

- Negative-amortization
- Interest-only or balloon-payment features
- Term exceeding 30 years
- Points and fees exceeding corresponding QM limit

QM Special Rules

Small-creditor QM *continued*

- QM status is lost if loan is sold or transferred within three years of consummation
- Limited exception applies if loan is sold under one of the following conditions:
  - Sold more than three years after consummation
  - Sold to another creditor that meets the criteria regarding number of originations and asset size, any time
  - Sold pursuant to a supervisory action or agreement, any time
  - Transferred as part of a merger or acquisition of or by the creditor, any time

QM Readiness Checklist

- ✓ Transaction terms provide for regular, substantially equal, periodic payments or the exception for adjustable- or step-rate mortgages applies
- ✓ Transaction term does not exceed 30 years
- ✓ Amount of total points and fees payable in connection with the transaction is correctly calculated
- ✓ Amount of total points and fees is within limit of 3% of the total loan amount, for loan amounts greater than or equal to $100,000
- ✓ Loan underwriting calculates the monthly payment for principal and interest correctly. Monthly payment must be calculated using maximum interest rate that may apply during the first five years after the date the first payment is due.

QM Readiness Checklist

Continued

- ✓ Loan underwriting properly accounts for the monthly payment for mortgage-related obligations
- ✓ Consumer's income or assets, other than the value of the security, are considered and verified in accordance with the standards of Appendix Q
- ✓ Consumer's current debt obligations, including any alimony and child support, are considered and verified in accordance with Appendix Q
- ✓ Ratio of consumer's total monthly debt to total monthly income at consummation does not exceed 43% calculated using Appendix Q

QM Readiness Checklist

Finance Charges	
<u>Include</u> Finance Charges Finance charges are determined in accordance with Regulation Z, 1026.4	**<u>Exclude</u> the following Finance Charges:** Interest or time-price differential; Federal/state Mortgage Insurance Premium (MIP) or Guarantee fee
<u>Include</u> portion of Private Mortgage Insurance (PMI) Upfront premium exceeding amount of current FHA upfront MIP	**<u>Exclude</u> PMI premiums** *only as follows*: amount of Private Mortgage Insurance upfront premium *up to* the amount of current FHA upfront MIP; monthly or annual premium *payable after consummation;*
<u>Include</u> third-party charges *retained by* institution or affiliate	**<u>Exclude</u> bona-fide third party charges not retained by institution or affiliate**

QM Readiness Checklist

Finance charges *continued*	
<u>Include</u> real-estate related fees even if excluded from the finance charge, if paid to an affiliate of the institution	**<u>Exclude</u> real-estate related fees *only if*** charge is reasonable; and institution receives no direct/ indirect compensation connected to charge; and charge is not paid to an affiliate
<u>Include</u> discount points as follows based on the extent to which the loan's interest rate exceeds the applicable APOR: All discount points included if rate exceeds APOR by more than 2 percentage points	**<u>Exclude</u> *bona-fide discount points only as follows:*** Up to two points, included if rate does not exceed APOR by more than 1 percentage point; One point only, if rate exceeds APOR by no more than 2 percentage points, but more than 1 percentage point

QM Readiness Checklist

Loan Originator Compensation	
Include Loan Originator Compensation paid directly or indirectly by a consumer or creditor to a loan originator **Also include:** Compensation paid by a consumer or creditor to mortgage broker a manufactured home retailer, and compensation included in the sales price of a manufactured home, if known	**Exclude Loan Originator Compensation if paid BY a broker, creditor, or retailer TO an employee** **Also exclude:** Compensation paid directly by consumer to a mortgage broker **only if** the amount has already been included in the calculation as a finance charge
Prepayment penalties	
Include prepayment penalties as follows: Amount maximum prepayment penalty that a consumer may be charged in connection with the transaction If the transaction is a refinance of a loan currently held by the institution or an affiliate, include amount of any prepayment penalty paid in connection with the loan being paid	

Thank You

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