Deloitte.

First look

Implications of the ability-to-repay rule and the qualified mortgage definition

Contents

A new beginning

On January 10, 2013, the Consumer Financial Protection Bureau (CFPB) issued the ability-to-repay (ATR) and the qualified mortgage (QM) rule — one of its "most important rules" yet.[1] This rule is "designed to assure the reliability of mortgages — making sure that lenders offer mortgages that consumers can actually afford to pay back."[2]

Since the CFPB released the rule, there has been a fair amount of market commentary that — not surprisingly — is mixed in its assessment. Nevertheless, as many have pointed out, this has all the signs of a watershed event, establishing a new baseline and codifying residential mortgage lending standards going forward.[3]

The impact of the ATR rule and the QM definition is not limited to origination activities alone. In fact, they have broad implications across the entire mortgage lifecycle, from origination to default management. The effects are likely to resonate in multiple areas. In addition to specifying new underwriting standards, lenders will feel the impact with respect to their potential funding sources, as well as loan servicing, operations, and compliance. Over the next year, full integration will need to be coordinated and balanced with several anticipated and related rules such as the qualified residential mortgage (QRM) rule/risk retention and new servicing standards. Collectively, these rules will establish the new state of play in residential mortgage finance.

The industry has about one year left — until January 10, 2014, when the rule becomes effective — to prepare itself for a new qualified mortgage world. In the ensuing months, market participants will be challenged as they contend with a range of business model and operational issues.

The new ability-to-repay and qualified mortgage rule is considered "one of the most important rules yet."

– Richard Cordray, Director, CFPB

[1] Richard Cordray, "Assuring consumers have the mortgages they can trust," Consumer Financial Protection Bureau Blog, January 10, 2013 (http://www.consumerfinance.gov/blog/assuring-consumers-have-access-to-mortgages-they-can-trust//).

[2] *Ibid.*

[3] Ian McEndry, "CFPB Qualified Mortgage Rule Mostly Commended; Some Concern," *Market News International*, January 11, 2013.

The ability-to-repay rule and the qualified mortgage definition

The CFPB's ATR rule amends Regulation Z, which implements the Truth in Lending Act.[4] Under this rule, a lender must fully verify that a borrower has sufficient income and/or assets to afford the mortgage over the life of the loan. It is, as the CFPB argues, an important step to protect consumers from poor underwriting standards.[5]

The ATR rule requires lenders to consider, at a minimum, the following eight underwriting criteria in the lending decision: (1) income or assets; (2) employment status; (3) credit history; (4) monthly payment for the mortgage; (5) monthly payments on other loans associated with the property; (6) other mortgage-related obligations, such as property taxes; (7) other debt obligations; and (8) the borrower's debt-to-income (DTI) ratio.

Additionally, lenders can no longer judge one's ability to repay a loan based off an introductory or "teaser" rate without regard for affordability after the interest rate resets, a practice frequently undertaken during the mortgage boom.

As a way to assist lenders to achieve compliance with the ATR requirement, the CFPB outlined the "qualified mortgage" definition for loans that meet certain characteristics set forth in the rule. Generally, QMs have limits on upfront fees, cannot exceed 30 years in duration, or be negative-amortizing. Also, the DTI ratio for QMs cannot exceed 43 percent.

The rule provides two distinct classes of outcomes for lenders meeting the QM specifications: a legal **safe harbor**[6] for prime loans[7] and a **rebuttable presumption** for higher-priced or subprime loans.

For prime QMs, the legal safe harbor provides a level of assurance that the loan met the ATR requirements when originated. The safe harbor potentially clarifies and minimizes future litigation risk. If challenged by a defaulted borrower, a lender need only demonstrate that the loan was originated according to QM standards.

On the other hand, subprime QMs are given a rebuttable presumption, a lesser protection allowing a defaulted borrower to contest the lender's compliance with the ATR criteria in court. Although the borrower must prove that despite meeting QM standards, the lender did not make a reasonable and good faith effort in evaluating the borrower's ability to repay the loan, the simple threat of such claim could make such QM loans unappealing. Such loans are likely to contain the potential for higher litigation risk and greater litigation expenses.

What the ability-to-repay rule and qualified mortgage definition do:

- Define an ATR standard for mortgages, including eight borrower characteristics to be considered in the lending decision
- Create a QM definition that illustrates compliance with the ATR standard for loans with certain features and underwriting
- Outline two classes of treatment for qualified mortgages: a safe harbor for prime loans and a rebuttable presumption for subprime loans

4 Federal Reserve. Regulation Z. 12 CFR 226. http://www.federalreserve.gov/bankinforeg/reglisting.htm#Z

5 Consumer Financial Protection Bureau, "Assuring consumers have access to mortgages they can trust," January 10, 2013. http://www.consumerfinance.gov/blog/assuring-consumers-have-access-to-mortgages-they-can-trust/

6 Consumer Financial Protection Bureau. "Ability-to-Repay and Qualified Mortgage Standards under the Truth in Lending Act." 12 CFR Part 1026. http://files.consumerfinance.gov/f/201301_cfpb_final-rule_ability-to-repay.pdf

7 The rule defines "prime loan" as a mortgage whose interest rate does not exceed the average prime offer rate by 1.5 percentage points for first liens and 3.5 percentage points for subordinate liens. Mortgages that exceed these thresholds are considered "higher-priced" or "subprime." CFPB's final Ability-to-Repay rule. 12 CFR Part 1026. http://files.consumerfinance.gov/f/201301_cfpb_final-rule_ability-to-repay.pdf

As illustrated in Exhibit 1, this paper addresses potential implications of the ATR rule and QM definition across the entire mortgage lifecycle: origination, servicing, securitization, and default management.

Exhibit 1
Potential implications of the ability-to-repay rule and qualified mortgage definition across the mortgage lifecycle

Origination

- Prime QMs likely to dominate originations
- 43 percent debt-to-income limit to be a binding constraint
- Increased price competition for prime QM borrowers
- Limits on points and fees could impact affiliate structures
- Need for new origination processes, compliance controls, and training
- Thorough document management should be considered critical

Servicing

- More predictable, less costly servicing for prime QMs
- Increased complexity for subprime and non-QMs

Securitization

- Prime QMs and evolving economics of the government sponsored enterprises (GSEs) could revive private label residential mortgage backed securities (RMBS)
- Subprime and non-QM securitization unlikely to be in demand
- Greater product standardization
- QM sets the stage for coming risk-retention requirements

Default management

- Potentially lower default rates
- Increased compliance costs

The ability-to-repay rule and qualified mortgage definition will likely create a more uniform and standardized QM-dominated market, while leaving non-QM borrowers with fewer options at competitive pricing.

Origination

The impact of the ATR rule and the QM definition on origination activities is likely to be significant, especially in areas such as underwriting, product innovation, pricing, risk controls, document verification, and compliance. The rule will likely create three types of mortgages, all of which will be uniquely impacted: prime QMs, subprime QMs, and non-QMs.

Prime qualified mortgages likely to dominate originations

The risk of not satisfying the ATR criteria will likely drive most lenders to pare originations primarily to QMs. As shown in Exhibit 2, few loans are expected to be originated without the QM definition, as originating non-QM loans may leave lenders exposed to potential reputational, compliance, and litigation risks. Some lenders who cater to this non-QM market may be required to alter their business models, risk tolerance, and pricing.

Borrowers who do not meet the ATR standard will likely see decreased credit availability and increased borrowing costs, particularly in the subprime segment. Originators may initially subject subprime QMs to stricter underwriting requirements than the QM rule actually requires in order to build a stronger defense in the event that a borrower challenges compliance in court.

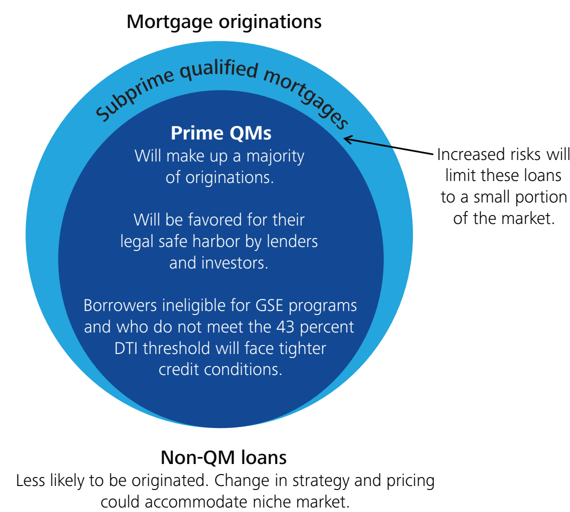
As a result, subprime QM origination costs will likely be higher to compensate lenders for the increased risk. The compounding effect will be highly restrictive credit to this segment of borrowers (fewer options and higher costs) as lenders assess a risk premium for such loans.

Also, borrowers with erratic or inconsistent income — such as the self-employed, contract workers, individuals with cyclical or seasonal employment, or those primarily reliant on investment income — will likely be challenged to meet some underwriting criteria despite strong credit histories, assets, or substantial down payments.

This more comprehensive and diligent underwriting standard effectively specifies new documentation standards for residential lending. Full documentation may permanently replace "no-doc" and Alt-A loans and other abbreviated verification programs. As is well known, no-doc/low-doc loans became all too common during the mortgage boom that preceded the financial downturn. However, since then, underwriting conditions have tightened considerably and most lenders are already subjecting residential mortgage loans to enhanced documentation criteria.

Exhibit 2

Prime qualified mortgages (QMs) to dominate residential mortgage originations



General skepticism of subprime and non-QM loans will likely decrease the liquidity and marketability of these assets, thus causing increased pricing and valuation challenges for market participants. Lenders will have to evaluate the accounting implications for originating and holding these loans given the probable absence of a liquid market.

43 percent DTI ratio to be a binding constraint

The QM definition also imposes a 43 percent total DTI threshold, a potentially challenging hurdle for even some prime borrowers. It will likely be the critical underwriting focus now for lenders, as other general underwriting conditions have already improved. Despite these tight underwriting criteria, from October 2010 to April 2012, 14 percent of originations exceeded the 43 percent DTI threshold, according to the American Bankers Association.[8]

This DTI threshold may restrict credit to some applicants in areas of higher housing costs, young and first-time homebuyers who may have limited income or existing loans from college or graduate school, and borrowers with existing debt. The rule may impose significant limitations on the amount of new mortgage credit available to these customer segments and further restrict their home-buying choices.

However, recognizing that the 43 percent DTI limitation might constrain lending to these sectors, the CFPB provided a temporary exemption from this threshold for loans that otherwise meet underwriting criteria for the GSEs — i.e., Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) — the U.S. Department of Housing and Urban Development, and certain other government agencies. This exemption will phase out if the GSEs' conservatorships end, should such agencies issue their own rules, or regardless, after seven years. This will likely be a meaningful exemption for conforming loans that do not meet the 43 percent DTI requirement and impact the balance of secondary market support between the GSEs and the private sector. It should be noted that loans falling into this exemption category do not need to be purchased by the GSEs, they simply need to meet the GSE eligibility criteria.

Notably, loans with balances in excess of GSE maximums (jumbo loans) will not qualify for this GSE exemption even if they meet all other GSE underwriting requirements. Given that significant segments of non-conforming and jumbo originations have historically exceeded the 43 percent DTI threshold and included affordability features such as interest-only payments, negative amortization, and pay option features, this sector of the origination market will likely experience supply challenges when the rule takes effect in January 2014, if not sooner. Niche lending and funding markets are expected to fill this void, although the timing and extent of these alternatives to the more standardized QM lending markets remains to be seen.

The rule also provides one other exemption from the ATR requirement for lenders refinancing "non-standard" loans, such as adjustable-rate mortgages with teaser introductory below-market interest rates, interest-only loans, or loans with negative amortization features, into "standard mortgages" with regular fully-amortizing payments, maximum terms, generally fixed interest rates, and QM limitations on upfront points and fees.

[8] American Bankers Association, "ABA says qualified mortgage rule should include safe harbor to preserve housing credit," July 10, 2012.

Increased price competition for prime QM borrowers

The ATR standard and QM definition further cement the bifurcated pricing tiers that exist today — with lower borrowing costs and greater supply of credit for prime QM-style borrowers and higher borrowing costs for others.

Lenders may aggressively seek borrowers who qualify for prime (safe harbor) QMs, as they can either more safely hold the loan in portfolio or more easily distribute it to the secondary market at competitive pricing. When combined with lower expected compliance costs and litigation risk, along with significantly better and more standardized pricing, prime QM borrowers should benefit from the pricing and supply advantages not likely to be present for the rest of the market.

While most loans being originated today likely qualify as prime loans under the rule, the concern about restricted credit to non-prime borrowers may become a growing political issue if underwriting standards reflected in the new rule result in little or no credit being offered to such borrowers.[9]

Limits on points and fees could impact affiliate structures

The CFPB's rule also sets a 3 percent limit on points and fees for QMs over $100,000 and other tiered limits for smaller mortgages. The points and fees measure includes all fees known at or before consummation and includes fees paid to the originator, creditor, and affiliates.

The 3 percent limit on points and fees is likely to add further pressure on pricing, leaving little room for inefficiencies and unanticipated costs, including appropriate risk premiums. As a result, lenders should be more highly disciplined in developing pricing structures at the risk of significant margin compression.

Additionally, because of the inclusion of fees by affiliates in this 3 percent limit, some lenders with large affiliate arrangements may need to revisit their business models — considering whether to continue to offer services such as title insurance and appraisals, which will be included in the points and fees limit, or spin them off to willing non-affiliate buyers. As a consequence, a new crop of non-affiliate service providers might come into being to offer these specialized services.

Such developments, if they do indeed occur, might in fact increase costs for consumers if the pricing on these ancillary services is higher than what the affiliate programs offer at the moment.

Along with the ATR/QM rule, the CFPB invited comments on how to include loan officer compensation in the points and fees calculation. A separate rule, also recently released by the CFPB, redefines the allowable types of compensation, which adds another layer of complexity to this issue.[10]

Also, at this time, it appears there is still some uncertainty around a few key aspects, such as the inclusion of compensation to branch managers and other parties involved in originating loans. Perhaps additional clarity on this matter will be provided by the CFPB in the near future.

[9] The CFPB estimated that 95 percent of current originations fit the qualified mortgage definition. Final Ability-to-Repay Rule. 12 CFR Part 1026. http://files.consumerfinance.gov/f/201301_cfpb_final-rule_ability-to-repay.pdf

[10] 10 CFPB, Concurrent Ability-to-Repay Proposal - Docket No. CFPB-2013-0002, January 10,2013. http://files.consumerfinance.gov/f/201301_cfpb_concurrent-proposal_ability-to-repay.pdf

Need for new origination processes, compliance controls, and training

Despite the tighter underwriting and origination standards currently in place, lenders may not be capturing all the data needed to prove ATR/QM compliance, either due to process deficiencies or outdated technology platforms. Institutions may need to reengineer some of their pre- and post- origination data collection procedures, loan application protocols, and approval processes to properly capture, analyze, and store the necessary information for compliance. Further, enabling technology platforms will need to be re-evaluated for suitability to the ATR and QM requirements. Employee training on the requirements of the rule will be necessary for all lenders as the regulation resets the standard for originations.

Thorough document management should be considered critical

As compliance costs and litigation potential pose significant risk for lenders, the ability to demonstrate compliance through strong, accurate, and reliable documentation should be considered a high priority. Under the rule, originators are required to retain records that show compliance for at least three years.

The rule provides strict penalties for not complying with the ATR standard. Lenders would be liable for "actual damages," which some borrowers could foreseeably claim includes the down payment, statutory damages, fees and up to three years of finance charges, and attorney fees.

HOEPA sheds light on the likely impact of the ability-to-repay rule

The regulatory response to abusive practices with home equity loans is a strong historical precedent for the likely impact of the ATR rule. In 1994, Congress passed the Home Ownership and Equity Protection Act (HOEPA),[11] creating protections for high-priced mortgages, which typically tend to be closed-end home equity loans that include annual percentage rates and fees over defined thresholds. HOEPA barred lenders from extending certain home equity loans without regard for borrowers' ability to repay the loan.

HOEPA imposed strict penalties for violators, increased liability for lenders, and subjected the responsibilities beyond the originator to the secondary market. Today, lenders issue very few loans that qualify for the HOEPA protections, regardless of market demand, for the same reasons they are not expected to issue non-QM loans: increased litigation, reputational, and compliance risk.[12] The secondary market, including the GSEs, has explicitly avoided purchasing loans that exceed HOEPA thresholds. While it is certainly possible to originate home equity loans that exceed HOEPA thresholds through safe and conservative underwriting, similar to what is anticipated for non-QM loans, they are at present essentially non-existent.

Much like the disappearance of loans that exceed the HOEPA thresholds, loans that do not meet the QM standard, regardless of how safe and well-underwritten they may be, are unlikely to be originated on a large scale, limiting credit availability for consumers who cannot meet the 43 percent debt-to-income limit or other characteristics.

[11] Federal Reserve. Regulation Z (Truth in Lending). 12 CFR Part 226. http://www.federalreserve.gov/boarddocs/press/boardacts/2001/200112142/attachment.pdf

[12] American Bankers Association comment letter to the Federal Reserve: Docket No. R-1417; RIN No. 7100-AD75. July 22, 2011.

Servicing

Servicing is another area likely to feel the repercussions of the CFPB's new rule, but perhaps not to the same extent as originations. There are two possible scenarios of a QM-dominated world for servicing.

More predictable, less costly servicing for prime qualified mortgages

The economics of residential mortgage servicing has recently been under severe pressure. Multiple regulations, recent actions including the Attorneys General National Mortgage Settlement, the Office of the Comptroller of the Currency's 2011 foreclosure review consent orders, the January 2013 settlement with 10 servicers,[13] and more recently the CFPB's January 17, 2013 release of new mortgage servicing standards, have servicers of all sizes redefining their infrastructure.[14]

However, the relatively more predictable nature of QM servicing due to stronger and uniform underwriting standards might ease some of the burden on servicers. The likelihood of default of these loans will likely be lower than loans from prior vintages, and in the event of default, the safe harbor is designed to minimize litigation and limit the resolution time for these loans. Apart from potentially costly compliance requirements imposed by other new regulations, the increased performance predictability expected from compliance with ATR and QM rules and the strong protections afforded by the safe harbor is expected over time to decrease the cost of servicing prime QMs.

Increased servicing costs for subprime and non-qualified mortgages

Subprime and non-QM loans might only be a very small part of the residential mortgage market going forward. Even if so, the economics of servicing such loans will likely be redefined.

The increased risks and compliance costs inherent in subprime and non-QM loans may exert more pressure on the servicing infrastructure, particularly when a loan defaults and the borrower, investor, or other third party seeks remedies. The potential for increased servicing burden will likely drive up the cost to effectively manage these assets.

If servicers correctly assess and price the costs of servicing subprime and non-QM loans, they have the potential to capture the risk premium often associated with these incremental activities. However, should portfolios perform even worse than expected, the likely long resolution periods expected with these loans will drive up the cost of servicing in the areas of advances, property preservation and maintenance, personnel costs, and litigation expenses. Accurately pricing the complete servicing costs of subprime and non-QM loans will likely be essential for servicers to operate profitably and safely.

[13] "OCC Takes Enforcement Action Against Eight Servicers for Unsafe and Unsound Foreclosure Practices." Office of the Comptroller of the Currency. April 13, 2011. http://www.occ.gov/news-issuances/news-releases/2011/nr-occ-2011-47.html

[14] "Consumer Financial Protection Bureau rules establish strong protections for homeowners facing foreclosure." Consumer Financial Protection Bureau. January 17, 2013. http://www.consumerfinance.gov/pressreleases/consumer-financial-protection-bureau-rules-establish-strong-protections-for-homeowners-facing-foreclosure/

Securitization

One of the consequences of the financial downturn has been the absence of the private label securitization market to provide funding to support new origination activity. Will the new ATR/QM rules provide greater certainty, at least for the prime QMs, and help revive investor appetite for residential mortgage-backed securities (RMBS) in the near future?

Prime QMs and evolving economics of the GSEs could revive private label RMBS

Greater underwriting, risk, and compliance reassurances for prime QMs stemming from the CFPB's rule may remove many of the uncertainties to the private-label securitization market and mortgage-backed securities. However, a broad resurgence in the private-label market will also likely be highly dependent on the ongoing evolution of the GSEs' governance, charter, and mission.

A majority of residential mortgages today that fit the GSE eligibility requirements are delivered to the GSEs because this distribution channel is the most cost-efficient method for originators to obtain secondary market funding. In contrast, the private-label securitization market has historically operated at a significant price disadvantage to the GSEs. The costs required to replicate the implicit government guarantee offered by the GSEs is expensive, time consuming, and fraught with third-party risk. As more residential loans are originated under ATR/QM, and the GSEs tighten eligibility requirements, there could be some leveling of costs and a shift in preference that might favor increased volume for private-label RMBS.

Subprime and non-QM securitization unlikely to be in demand

The absence of clearly measureable legal protections, an expected increase in servicing costs and uncertain performance for subprime and non-QMs will likely dampen investor appetite for securitization products backed by these loans, a similar response to securitization following the HOEPA legislation (see sidebar on page 7). The need for additional representation and warranty agreements and other related forms of protection, which would likely be priced into origination cost (further driving up the cost of credit to this segment), would still not guarantee an active and liquid secondary market given the alternatives available to investors.

In the future, a niche market may develop; but until then, the secondary market will not see the standardization, uniformity of process, or the scale required for a well-functioning market, leaving such originators of subprime and non-QM loans with few options: hold in portfolio or seek funding through whole loan sales or private placements, both of which are likely more expensive and less efficient alternatives.

Greater product standardization

The increased uniformity of prime QMs will likely benefit many elements of the securitization process. As parties evaluating credit and quality are able to more easily and efficiently analyze potential transactions, investors would have greater certainty of performance returns and dealers would better understand and consider risks as they structure more cost-effective capital raising for originators. This increased standardization could lower the overall cost of securitization and further support housing credit, particularly for prime jumbo QMs, which are more dependent on the private market for funding as they are not eligible for purchase by the GSEs.

Limits on prepayment penalties are likely a non-event

The rule's restriction of prepayment penalties to only prime fixed-rate mortgages is not expected to have broad implications for securitization. During the mortgage boom, prepayment penalties became fixtures on subprime loans. As the vast majority of today's originations are prime loans — mortgages that typically do not include prepayment penalties — the secondary market is accustomed to purchases without this feature.

Additionally, a potential future rise in interest rates will likely reduce borrowers' incentive to refinance, naturally limiting prepayment risk and extending the duration of mortgage assets.

QM sets the stage for coming risk retention requirements

In addition to the origination standards set forth in the ATR/QM rule, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)[15] also imposes risk retention requirements that are important for securitization. The law mandates that originators hold a 5 percent risk retention of securitized assets that are not sold to the GSEs. Lenders will have to retain the credit risk on their books and hold capital against that asset, limiting capital and funds that could otherwise be deployed for additional lending.

Institutions — particularly small lenders with limited access to capital, banks with less flexible balance sheets, or firms with "originate-to-distribute" models — may find themselves in a position where they have to turn down qualified borrowers because they are not able to retain the credit risk at that time.

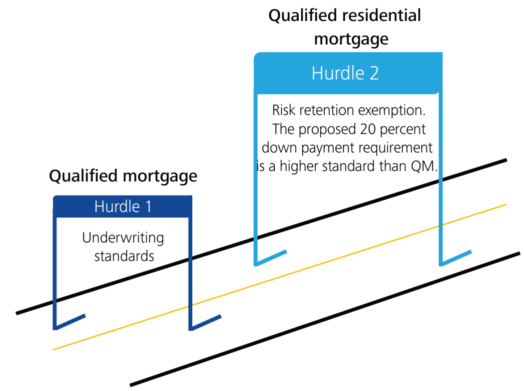
For this reason, the law created the qualified residential mortgage (QRM) designation, which exempts loans from the risk retention requirement through a two-hurdle process. Loans that meet the QM standard — the first hurdle — are then eligible to meet the additional requirements of the QRM, the second hurdle, and be exempt from risk retention. Because of the two-hurdle approach, the requirements of the QRM cannot be lower than those of QM.

Regulators can decide to make the requirements for both QM and QRM the same. However, this is not the path they have decided to take when crafting regulations to implement this portion of the Dodd-Frank Act. In 2011, regulators issued a draft of the QRM criteria that, among other features, required a 20 percent down payment.

The proposed 20 percent down payment threshold would likely restrict access to credit, particularly to first-time homebuyers and borrowers in areas of higher housing costs. Additionally, borrowers seeking jumbo loans may find themselves with fewer borrowing options as some institutions, especially smaller banks, may not be in a position to hold the credit risk if the borrower cannot afford a 20 percent down payment.

Two hurdles to overcome: QM and QRM

- QM is the first hurdle for mortgages.
- QRM is the second hurdle. It cannot be smaller than QM.
- Loans and securities that meet both QM and QRM will receive preferential pricing.



Now that the first hurdle — the qualified mortgage definition — is set, regulators may decide to revisit the risk retention draft before moving forward with a final rule.

Once the QRM rule is finalized, loans that meet the QRM standard, and thus also meet the QM standard, will likely enjoy preferential pricing as the lender will have the flexibility to sell the loan to the secondary market without holding the credit risk. Borrowers who are unable to satisfy the QM and/or QRM requirements may face both restricted mortgage credit and more expensive borrowing options.

[15] Public law 111-203. Title IX Section 11.2. http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf

Default management

Default management, once a relatively routine concern, became a highly vexing challenge for servicers, investors, and regulators following the financial downturn. The scale and variety of problems stemming from delinquencies and foreclosures, while finally showing signs of decline, are still haunting the lending and servicing industry on a number of fronts. To be sure, many changes have been made to accommodate regulators' demands and business exigencies. And the industry as a whole has adopted a number of new practices to better streamline and manage default management operations. These changes, while adding to the cost burdens facing the industry, may potentially be beneficial in the long run.

Broadly speaking, the ATR/QM rule might have both positive and negative implications for default management.

Potentially lower default rates

On the brighter side, the new rule might, in fact, lessen the incidence of future defaults due to the codification of more prudent underwriting standards already in place. Furthermore, this is particularly more likely if much of the mortgage lending is geared towards prime/lower-risk QM borrowers. Lower defaults — if they do indeed come to fruition — are a good thing for everyone, including borrowers themselves.

In this prime QM lower-default scenario, perhaps fewer resources need to be dedicated to default management activities. And the likely scaling up of these resources, if necessary, might be more gradual than what was witnessed recently when there was a sudden spike in default volumes for which many lenders were simply unprepared.

Increased compliance costs

On the negative side, there is an important consequence for default management.

Even for the prime QM loans that have safe harbor, prudent and comprehensive document management will be important in demonstrating compliance with ATR, even three years after origination. This is probably more important for those prime QMs that make it into the GSE pool or the private-label securitization market.

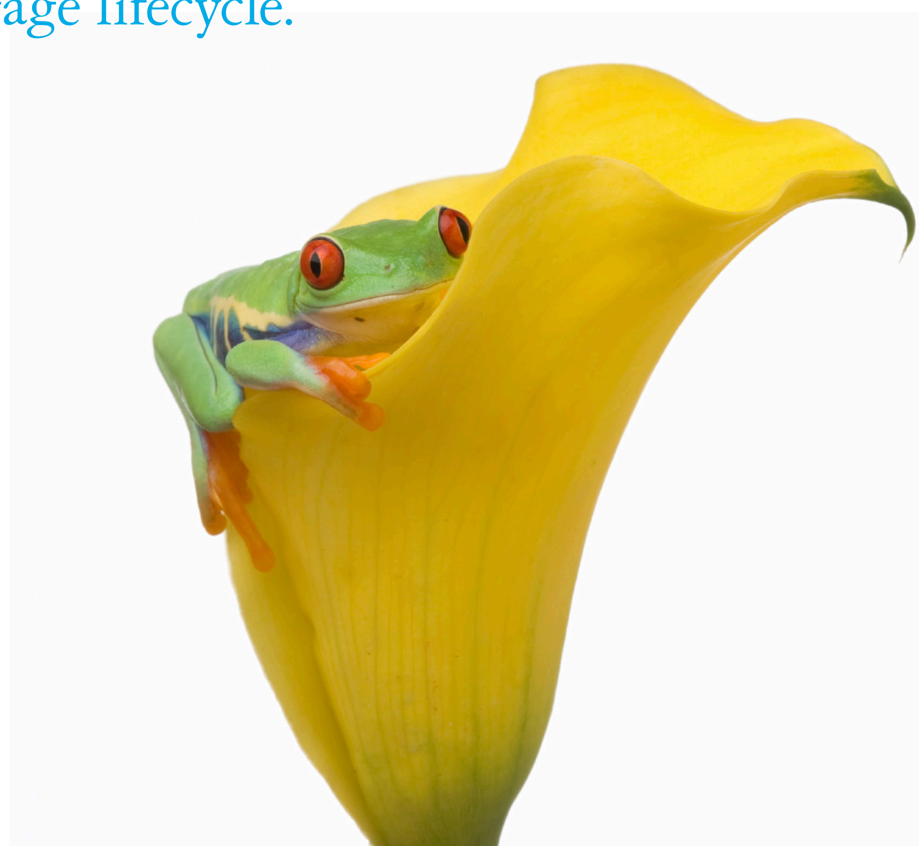
As for the subprime QMs and non-QMs, the compliance burden is likely to be greater even if such mortgages are retained on the books of the originators.

A measure of clarity

It is probably not an exaggeration to say that the new ATR criteria and the QM definition from the CFPB offer a measure of clarity, and will likely set the residential mortgage industry on a fresh, but possibly narrow, path in the future. The full implications of these new codes might not be known for some time but a preliminary assessment suggests that they are likely to be far-reaching, and may permanently impact many aspects through the mortgage lifecycle.

Depending on one's perspective, a year might or might not be sufficient to brace for the likely changes in the qualified mortgage world. As we highlight in this paper, there is much to contemplate and even more to do. The points raised here reflect a summary of some of the challenges facing the residential mortgage industry to help navigate the complexities of this new and far-reaching regulation.

This new rule is likely to be far-reaching, and may permanently impact many aspects of the entire mortgage lifecycle.



Contacts

Industry leadership

Bob Contri
Vice Chairman
U.S. Financial Services Leader
U.S. Banking and Securities Leader
Deloitte LLP
+1 212 436 2043
bcontri@deloitte.com

Deloitte Center for Financial Services

Jim Eckenrode
Executive Director
Deloitte Center for Financial Services
Deloitte Services LP
+1 617 585 4877
jeckenrode@deloitte.com

Deloitte Center for Regulatory Strategies

Tom Rollauer
Executive Director
Deloitte Center for Regulatory Strategies
Deloitte & Touche LLP
+1 212 436 4802
trollauer@deloitte.com

Authors

Val Srinivas
Head of Research, Banking & Securities
Deloitte Center for Financial Services
+1 212 436 3384
vsrinivas@deloitte.com

Ryan Zagone
Senior Research Consultant
Deloitte Center for Financial Services
+1 212 436 2346
rzagone@deloitte.com

Contributors

John Corston, director, Deloitte & Touche LLP
Liz Jordan, director, Deloitte & Touche LLP
Howard Kaplan, partner, Deloitte & Touche LLP
Christine Lee, partner, Deloitte & Touche LLP
Phoebe Moreo, partner, Deloitte & Touche LLP
Madeline Morris, director, Deloitte & Touche LLP
Guy Sindle, partner, Deloitte & Touche LLP
Chris Spoth, director, Deloitte & Touche LLP
Tom Tanguay, partner, Deloitte & Touche LLP
Drew Tyrie, principal, Deloitte Consulting LLP
Mojgan Vakili, partner, Deloitte & Touche LLP

The Centers wish to thank the following additional Deloitte professionals for their contributions and support:
Beth Leesemann-Araujo, senior associate, Deloitte Services LP
Cara Buerger, senior graphic designer, Deloitte Services LP
Michelle Chodosh, manager, Deloitte Services LP
Kristy Coviello, senior manager, Deloitte Services LP
Lauren Fischer, associate, Deloitte Services LP
Lisa DeGreif Lauterbach, marketing leader, Deloitte Services LP
Christie Murphy, external communications coordinator, Deloitte & Touche LLP
Seth Raskin, manager, Deloitte Services LP

The new ATR criteria and QM definition will likely set the residential mortgage industry on a fresh, but possibly narrow, path in the future.

About the Deloitte Center for Financial Services
The Deloitte Center for Financial Services supports Deloitte's U.S. financial services practice in providing actionable insights and research to help guide senior-level decision makers within banks, capital markets firms, mutual fund companies, private equity firms, hedge funds, insurance carriers, and real estate organizations operating globally.

The Center is staffed by a group of professionals with a wide array of in-depth industry experience as well as cutting-edge research and analytical skills. Through its research and events, Deloitte's clients have access to a trusted source for relevant, timely, and innovative insights.

About the Deloitte Center for Regulatory Strategies
The Deloitte Center for Regulatory Strategies provides valuable insight to help organizations in the financial services, health care, life sciences, and energy industries keep abreast of emerging regulatory and compliance requirements, regulatory implementation leading practices, and other regulatory trends. Home to a team of experienced executives, former regulators, and Deloitte professionals with extensive experience solving complex regulatory issues, the Center exists to bring relevant information and specialized perspectives to our clients through a range of media including thought leadership, research, forums, webcasts, and events.

www.deloitte.com/us/centerregulatorystrategies

About Deloitte
Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms. Please see www.deloitte.com/us/about for a detailed description of the legal structure of Deloitte LLP and its subsidiaries. Certain services may not be available to attest clients under the rules and regulations of public accounting.