

Updated March 11, 2021

The Qualified Mortgage (QM) Rule and Recent Revisions

Background

Prior to the 2008 financial crisis, mortgage underwriting standards were relaxed such that the ability of borrowers to repay their loans became linked to the favorable financial conditions that existed at the time of origination. Following a rise in interest rates and a decline in underlying collateral values (house prices), these less favorable market conditions generated mortgage delinquencies and defaults.

The 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203) sought to address this in part by including an *ability-to-repay* (ATR) requirement. On January 30, 2013, the Consumer Financial Protection Bureau (CFPB) finalized a rule implementing the ATR. The initial version of the ATR rule became effective on January 10, 2014. A revised ATR rule, discussed below, was published on December 29, 2020. This, however, may not be the last revision, as another proposed rule was issued on March 3, 2021.

The ATR requires a lender to make a reasonable good faith determination of the consumer's ability to repay the loan according to its terms. Before making a residential mortgage loan to a consumer, a lender must consider and verify with documentation eight underwriting criteria for the borrower: (1) current or reasonably expected income or assets; (2) current employment status; (3) monthly payments of principal and interest on the primary mortgage lien; (4) monthly payment on any junior mortgage lien; (5) monthly payment for mortgage-related obligations (e.g., property taxes, homeowner association fees); (6) any additional debt (e.g., automobile, credit card, education) obligations; (7) monthly debt-to-income (DTI) ratio or residual income; and (8) credit history.

The ATR rule provides multiple ways for a loan originator to comply for legal purposes, one of which is by originating a general *qualified mortgage* (QM). A general QM must meet certain product-feature and underwriting requirements:

- The mortgage must fully amortize, meaning that the borrower's payments must be applied toward paying down a portion of the principal loan balance over time. A general QM cannot have a balloon or large principal payment due at the end of the loan. Furthermore, a general QM loan cannot *negatively* amortize, meaning that its principal loan balance cannot increase over time.
- For a *safe harbor* general QM loan, the difference between the annual percentage rate (APR) and the average prime offer rate (APOR) must not exceed 1.5 percentage points for a first lien and 3.5 percentage points for a junior lien. The APR includes both the

annual interest cost and upfront fees spread over the life of the mortgage and expressed as a percentage. The APOR is a weekly average of the market rates and points (upfront fees) found in the Primary Mortgage Market Survey conducted by Freddie Mac. The legal protection provided by a safe harbor general QM means that a borrower would not be able to assert that the originator (and any subsequent secondary-market purchaser) failed to comply with any of the required underwriting criteria.

- For a *rebuttable presumption* general QM, the difference between APR and APOR for first-lien mortgages may exceed 1.5 percentage points, but it is limited to 2.25 percentage points under the revised final rule. Under a rebuttable presumption, a borrower can argue that the lender violated the ATR rule if the information presented to the lender during the loan application and origination processes would have indicated that the borrower's residual income was insufficient to meet living expenses after paying the mortgage and other debts.

Revisiting the 43% DTI Requirement

Limiting the borrower's DTI to 43% was originally one of the underwriting requirements for a loan to receive safe harbor QM status. Mortgages with DTIs exceeding 43% still receive QM status if they meet the eligibility requirements to be insured or guaranteed by the Federal Housing Administration (FHA), U.S. Department of Veterans Affairs (VA), or U.S. Department of Agriculture (USDA). Mortgages with DTIs exceeding 43% could also qualify under another QM category, the *Temporary GSE QM* (or *QM patch*). The Temporary GSE QM had initially granted safe harbor QM status to mortgages eligible for purchase by Fannie Mae or Freddie Mac, two government-sponsored enterprises (GSEs), until January 10, 2021.

In January 2019, the CFPB released an assessment report of the ATR and QM rule, reaching conclusions similar to those reported by some private-sector researchers. The CFPB found that many originators limited their offerings to mostly QM loans, and the DTI cap of 43% may have restricted credit access. For example, the CFPB reported that the approval rates for non-QM high-DTI applicants declined across all credit tiers and income groupings since the QM rule took effect. Existing mortgage borrowers who had demonstrated the ability to repay their loans—but with DTIs exceeding 43%—experienced reductions in credit access when attempting to refinance. These findings are consistent with lenders' preference for safe harbor legal protection. The CFPB also reported that originators perceive Appendix Q—the list of required guidelines to verify borrowers' incomes and debt obligations for

mortgages with DTIs above 43% or ineligible for sale to the GSEs or for federal mortgage insurance—to be unclear and complex in practice. In short, lenders lacked legal certainty that the use of Appendix Q would guarantee legal protection.

The CFPB also found that borrowers who applied for loans eligible for purchase or guarantee by one of the GSEs or federal agencies were less affected by the QM rule. The QM status received when mortgages are federally guaranteed along with the Temporary GSE QM patch generally increased in importance as a result of many originators choosing to make primarily QM loans and reduce exposure to potential liability and litigation risks.

Revised and Expanded QM Definitions

The CFPB has since revisited the QM definitions to possibly achieve a better balance between ensuring a consumer’s ability to repay and access to affordable mortgage credit. On December 29, 2020, the CFPB published a final rule amending the definitions of the general QM. The final rule is effective on March 1, 2021, meaning that prepared creditors may opt to comply with the revised general QM definition for applications received on or after that date. The mandatory compliance date is July 1, 2021, and applies to all applications received on or after that date. On October 20, 2020, the sunset date for the Temporary GSE QM definition was replaced with a provision stating that it would be extended until the mandatory compliance date of the final rule amending the general QM definition. Consequently, the Temporary GSE QM definition sunsets on July 1, 2021 if the final rule stays in place. Some revisions include the following:

- For the safe harbor general QM definition, the final rule retains existing product features, underwriting requirements, and limits on points and fees. The 43% DTI ratio requirement, however, is replaced with requirements based on the mortgage pricing that reflects the credit quality of borrowers. The rule continues to grant safe harbor QM status to a first-lien (primary) mortgage in which the difference between its APR and the APOR does not exceed 1.5 percentage points—or 3.5 percentage points for a subordinate-lien (secondary) mortgage. Although a loan’s price is not a direct measure of the ability to repay, the CFPB concludes that it is an effective indirect measure.
- The final rule removes Appendix Q and allows creditors to use verification standards specified by the CFPB, which include relevant provisions from the seller and servicing guides of Fannie Mae, Freddie Mac, FHA, VA, and USDA.
- The final rule provides an increase in the loan amount thresholds for first-lien loans with smaller balances and subordinate liens, which tend to have higher APRs, for QM status. A first lien secured by a manufactured home (as defined under federal regulations that establish construction and safety standards) may also be eligible for QM status. The final rule provides the relevant thresholds that the APRs would be allowed to exceed the APOR under certain circumstances.

In an accompanying rule, the CFPB also finalized a seasoned QM loan definition. A seasoned QM is defined as a first-lien, fixed rate loan that has met certain performance standards after being held in the portfolio of the originating lender for at least 36 months, referred to as a seasoning period. Over the seasoning period, a loan can have no more than two delinquencies of 30 days or more and no delinquencies of 60 days. A seasoned QM must still comply with restrictions on product features, points, and fees and meet certain underwriting requirements. Hence, a loan with an ATR rebuttable presumption can be seasoned into a safe harbor QM and possibly encourage lending in markets such as manufactured housing originations, which may not typically be eligible for safe harbor legal protections. The effective and compliance dates for the seasoned QM align with those for the general QM final rule.

The incoming acting director of the CFPB has raised concerns about the revised QM rule, directing the CFPB staff to “[e]xplore options for preserving the status quo.” On March 3, 2021, the CFPB released a notice of proposed rulemaking to delay the mandatory compliance date of the general QM final rule from July 1, 2021, to October 1, 2022.

Additional Resources

CFPB, “Ability-to-Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z),” 78 *Federal Register* 6408-6620, January 30, 2013.

CFPB, “Qualified Mortgage Definition Under the Truth in Lending Act (Regulation Z): General QM Loan Definition,” 85 *Federal Register* 86308-86400, December 29, 2020.

CFPB, “Qualified Mortgage Definition Under the Truth in Lending Act (Regulation Z): Seasoned QM Loan Definition,” 85 *Federal Register* 86402-86455, December 29, 2020.

CFPB, “Qualified Mortgage Definition Under the Truth in Lending Act (Regulation Z): Extension of Sunset Date,” 85 *Federal Register* 67938-67960, October 26, 2020.

CFPB, *Ability-to-Repay and Qualified Mortgage Rule Assessment Report*, January 2019, https://files.consumerfinance.gov/f/documents/cfpb_ability-to-repay-qualified-mortgage_assessment-report.pdf.

Department of Housing and Urban Development, “Qualified Mortgage Definition for HUD Insured and Guaranteed Single Family Mortgages,” 78 *Federal Register* 75215-75238, December 13, 2013.

Department of Veterans Affairs, “Loan Guaranty: Ability-to-Repay Standards and Qualified Mortgage Definition Under the Truth in Lending Act,” 79 *Federal Register* 26620-26628, May 9, 2014.

Department of Agriculture, Rural Housing Service, “Single Family Housing Guaranteed Loan Program,” 81 *Federal Register* 26461-26465, May 3, 2016.

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