Welcome to the QRM Webinar for Minnesota

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The QRM Rule: Observations and Analysis

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Overview

- Description of the risk retention rule
- Qualified residential mortgages (QRMs)
- Concerns raised by the rule
- Other issues
- Proposed comments?
- Next steps and prognostications

The Proposed Risk Retention Rule

- Proposed rule published March 31, 2011
- Implements risk retention requirements in section 15G of the Securities Exchange Act of 1934 (15. U.S.C. § 78o-11) as amended by section 941(b) of the *Dodd-Frank Wall Street Reform and Consumer Protection Act*.
- Issued on by 6 regulators:
  - Federal Reserve Board of Governors (Fed)
  - Office of the Comptroller of the Currency (OCC)
  - Federal Deposit Insurance Corporation (FDIC)
  - Department of Housing and Urban Development (HUD)
  - Federal Housing Finance Agency (FHFA)
  - Securities and Exchange Commission (SEC)

Purpose of the Rule

- “Risk retention” = “skin in the game”
- Replaces “reps and warrants” and “originate to distribute”
- Sponsors of Asset-Backed Securities (ABS) must hold 5% of the credit risk in a securitization
- Prohibits hedging or transfers of this risk
- Protects investors and provides incentives to ensure that loans are well-underwritten

Options for Risk Retention

- Vertical risk retention: (5% of each class of security)
- Horizontal risk retention (5% of the par value, first loss residual)
- L-shaped: Combination of horizontal and vertical risk retention
- Retention of a representative sample equal to 5% of UPB of the pool
- Other:
  - Requires investor disclosures of material information on retained interests
  - Sponsors not allowed to transfer or hedge the risk
  - Can shift risk to originator, if originator has 20% of the assets in the pool

Exemptions from Risk Retention

- Federal Housing Administration (FHA) loans are excluded
- Fannie Mae and Freddie Mac also exempt – so long at they are in conservatorship or receivership by the federal government
- Qualified Residential Mortgages as defined by the rule

How Does the Rule Affect the Market?

- Three options for an originator of a mortgage
  - Hold in portfolio
  - Sell as a correspondent
  - Securitize
    - FHA
    - Fannie Mae and Freddie Mac
    - Private Label Securities -- PLS (QRM)
    - Private Label Securities -- PLS (non-QRM)

Qualified Residential Mortgages (QRMs)

- Securities collateralized exclusively by QRMs are exempt from retention
- Regulators have defined as a loan of very high credit quality
- Standards:
    - No: IOs, neg ams, balloons, excessive payment shocks (200 bps in 12 months, 600 bps over life of loan), terms no longer than 30 yrs, or prepayments penalties
    - Maximum loan-to-value (LTV) ratio of 80% or 20% down payment requirement in a purchase transaction
    - Maximum combined LTV of 75% for refinance transactions – 70% for cash-out refinances
    - Maximum front-end and back-end debt-to-income ratios of 28% and 36%
    - No credit history derogatory factors: Not 30 days late, no 60-day delinquencies on any debt obligation in previous 24 months; no bankruptcy, foreclosure, deed in lieu or credit judgments over last 36 months

Concerns

- Overly constrained definition of a QRM
- Stigmatizes low-down lending and borrowers that do not meet QRM
- Makes low-down payment lending province of FHA
- Increases the cost of mortgage lending for low-income borrowers
- Reduces mortgage liquidity – and availability of credit
- Exacerbates industry concentration
- Does rule encourage or block the emergence of a PLS market?

Down Payment Requirements

- Proposal to establish 20 percent down is overly onerous.
- Over-emphasizes down payment at the expense of other underwriting criteria, documentation, and/or product types
- Experience shown that we can do affordable low-down payment homeownership programs successfully and sustainably.
- Would set back the opportunity for homeownership:
  - Median house price is $172,100. Twenty percent down implies a down payment of $34,420 before an estimated 5% of sales price for closing costs
  - Median rental household net worth in 2007 was $7,500 for non-Hispanic whites and $2,500 for minority households.
  - Even more pronounced for low-income families in high-cost markets.

Affordable Homeownership Programs

- Policy punishes responsible low-income homeownership programs for the sins of the predatory and abusive lenders
- Down payment assistance must be a gift or a grant – cannot be a loan
- Need to distinguish between responsible and irresponsible seconds
  - Regulation talks about the default history from piggybacks
  - Well structured soft second loans increase affordability and recapture public subsidies

Debt to Income (DTI) Ratio

- Rule proposes 28% front-end and 36% back-end ratio
- Antiquated underwriting standard
- Modern underwriting looked at layered risks and offsetting factors
- Overlooks the interactive effects with other risk factors
- Problem of a bright line standard
- Some would preserve front-end standard as measure of affordability

Other Issues

- Premium capture cash reserve
- Macro hedges
- Role of mortgage insurance

Difficult Context in Which to Assess Policy

- Market still under duress: Foreclosures, REO, Underwater mortgages
- Significant policy changes in the works
- Raising FHA premiums and GSE g-fees
- NSP ending; counseling program de-funded
- Qualified mortgage rule proposed
- Other Dodd-Frank provisions in process: CFPB
- Future of Fannie Mae and Freddie Mac unresolved
- Basel III International Capital Standards

Ability to Pay/Qualified Mortgage

- The issued Qualified Mortgage Rule under TILA (Reg Z)
- Creditors must determine the consumer's ability to pay
- General Standard: Lender must consider and verify 8 factors:
  - Income and assets, Current employment, monthly payment, monthly payment on any simultaneous mortgage, monthly payment on mortgage-related obligations (e.g. taxes), other debt, credit history, monthly DTI ARM
- Refinance nonstandard mortgage into a standard mortgage (streamline)
- Qualified Mortgage (A): Legal safe harbor
  - No neg am, IO or balloon, or loan term > 30 years, points and fees not > 3%
- Qualified Mortgage (B): Rebuttal presumption of compliance
  - Option A + General Standards
- Comments to Consumer Financial Protection Bureau July 22, 2011.

Proposed Commentary: Part I

- Broaden the definition of a QRM
- Make the QRM more consistent with QM and responsible homeownership
  - A good mortgage is a qualified mortgage – eliminates harmful loan features, considers layered risks, is available to borrowers of all incomes
- Eliminate down payment as a criteria
  - Inconsistent with legislative history
  - Rule overemphasizes down payment as a feature of a good loan
  - Well structured, well underwritten, fully documented 95% /97% LTV loans have performed well despite the crisis
- DTI requirement also needs to be rethought
- Support responsible affordable low-income homeownership

Proposed Commentary: Part II

- What if regulators are unwilling to drop down payment? Or lowered it to 10% down?
- Is the alternative, then, to broaden the definition of non-QRM: Raise down payment requirement to 30 or 40%?
- Create a larger market for non-QRM mortgages, move farther away from what could look like an underwriting standard, lessen the stigma for non-qualified loans?

Process and Next Steps

- QRM Comments Due June 10, 2011
  - “Credit Risk Retention”
  - Forward to appropriate regulator
- QM Comments Due July 22, 2011
- Market needs to find the bottom
- Future of Fannie Mae and Freddie Mac still to come
- Policymakers will need to recalibrate

Thank You

Please join us for the Live Panel Discussion:
Thursday, June 16th, 8 - 11:30 am CST
Wilder Foundation, 451 Lexington Pkwy N.
St. Paul,MN

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For commentaries and original regulatory text, go to the MHP webpage on the Dodd-Frank Financial Reform Act
http://tinyurl.com/3tu9zun