QRM and Risk Retention Standards: Foundation for a Sound Housing Market

(Part II of IV)

By Faith A. Schwartz, Margarita S. Brose and Stuart I. Quinn
Executive Summary

The Aug. 28, 2013 release for comment of the re-proposed Credit Risk Retention (CRR) rule by the Office of the Comptroller of the Currency, the Securities and Exchange Commission and other banking and housing regulators was eagerly awaited by investors and the mortgage industry.

First proposed more than two years ago, the CRR rule was drafted pursuant to the requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The CRR section of the Dodd-Frank Act sought to address issues in the securitization market which, the legislators believed, contributed to the financial market collapse in 2008. The goal of the rule was to require securitizers to have skin in the game through risk retention on securitization transactions—while preserving access to affordable credit. The CRR rule, among other things, addresses the definition of a Qualified Residential Mortgage (QRM) as it pertains to the securitization of mortgages sold to investors.

The re-issuance of the proposed CRR rule raises some new questions. The CRR rule sets out the risk retention provisions for securitizers that underwrite asset-backed securities (ABS), but it also exempts from those provisions all ABS underwritten by the housing agencies (or MBS). Given that exemption, what are the incentives for private securitization where there is capital relief in the alternative?

There are two alternatives identified in the re-proposed QRM rules. The first is consistent with the QM definition of the Ability to Repay (ATR) Rule. The second calls for a significant down payment of 30 percent on top of QM-like rules. Although the CRR rule seeks consistency in its QRM definition with the Consumer Financial Protection Bureau’s recent rulemaking regarding consumer mortgages, the QRM exemption criteria result in private securitizers and investors bearing the risk, and therefore the cost, of underwriting ABS that include pools of these non-exempt mortgages.

The question remains whether this alignment may have a significant impact on pricing these loans, putting some loans out of reach for the market. Also unknown is whether loans outside the standard, such as jumbo loans, will be included in pools of mortgages considered for securitization. In any event, these are important issues to explore with regard to the return of a fully functioning and healthy securitization market. We explore some of these issues in this second paper in our series, “Foundation for a Sound Housing Market.”
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On Aug. 28, 2013, the Office of the Comptroller of the Currency, the Securities and Exchange Commission and other housing and banking agencies (collectively, “the agencies”) released the re-proposed Credit Risk Retention (CRR) rule for comment. It was eagerly awaited by investors and the mortgage industry.¹

First proposed more than two years ago, the CRR rule was drafted pursuant to the requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The CRR section of the Dodd-Frank Act sought to address issues in the securitization market which, the legislators believed, contributed to the financial market collapse in 2008.² The goal of the rule was to limit credit risk on asset-backed securities (ABS) while preserving access to affordable credit. The CRR rule, among other things, addresses the definition of a Qualified Residential Mortgage (QRM) as it pertains to the securitization of mortgages sold to investors.

As described in more detail below, the re-issuance of the proposed CRR rule raises some new questions for housing finance market participants. The CRR rule sets out the risk-retention provisions for securitizers who underwrite ABS, but it also exempts from those provisions all ABS³ (for this discussion, mortgage-backed securities (MBS)) underwritten by the housing agencies⁴. Given that exemption, what are the incentives for private securitization of non-exempt loans where there is capital relief in the alternative? Although QRM as defined in the CRR rule is consistent with the Consumer Financial Protection Bureau’s (CFPB) recent rulemaking regarding consumer mortgages, the QRM exemption criteria result in private securitizers and investors bearing the risk, and therefore the cost, of underwriting MBS that include pools of these non-exempt mortgages. The question remains whether this alignment may have a significant impact on pricing these loans, which may result in some of these loans being out of reach for the market. Also unknown is whether loans falling outside the standard, such as jumbo loans, will be priced and included in pools of mortgages considered for securitization. These are important issues to explore with regard to the return of a fully functioning and balanced securitization market.

History of the Rule

The CRR rule has been through two iterations, both of which contained an alternative proposal:

(1) In March 2011, the first rule was proposed, along with a 10 percent down-payment alternative;

(2) the re-proposal aligning QRM to the Qualified Mortgage (QM) and a Qualified Mortgage Plus, or 30 percent down alternative, closed for comment on Oct. 30, 2013.

The March 2011 proposal received extensive feedback from the banking, consumer and investor communities, some of which was incorporated into the re-proposed rule in 2013. Two key provisions left out of the re-proposed rule were the

¹ The agencies also include the Federal Reserve Board, the Federal Deposit Insurance Corporation (FDIC), the Federal Housing and Finance Agency (FHFA) and Housing and Urban Development (HUD).
³ Asset-backed securities are defined in the CRR rule.
⁴ The housing agencies include the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac).
down-payment requirement under the QRM definition and the premium capture cash reserve account (PCCRA) requirement under the risk retention provisions.

Approximately 10,500 people, institutions or groups that commented on the March 2011 proposal made a persuasive argument to the rule writers that, among other things, the down-payment provision would likely be restrictive and eliminate a vast number of otherwise sound residential mortgages from the exemption. In addition, many members of Congress weighed in that the 20 percent down-payment provision was counter to the legislative intent of the Dodd-Frank Act, and requested its exclusion from the rule. Likewise, the PCCRA requirement was considered restrictive by some commenters, and in the re-proposed rule the agencies suggest alternative approaches to the risk retention requirements that the PCCRA was originally intended to address. The 5 percent credit risk retention calculation is now proposed to be based on fair value, in a nod to the commenters. The agencies gave the public two months to respond to the re-proposed CRR rule, which closed for comment on Oct. 30, 2013.

Securitized residential mortgage loans (a type of asset-backed securities, also known as residential mortgage-backed securities—RMBS or simply MBS)) had become an important product not only in the U.S. but in the international capital markets leading up to the financial crisis, and the collapse of the financial system in 2008 was caused in no small part by the collapse of the mortgage markets. These securities were significantly downgraded and devalued when homeowners and loan holders could no longer make payments due on the mortgages bundled into MBS or held on balance sheets.

During the run up to the housing bubble, when home prices were predicted to keep rising, the mortgage industry, initially private loan originators, loaned money to individuals without fully documenting and/or ensuring the borrowers' ability to repay. Loan products were sold to prospective homeowners with the assurance that the mortgage was affordable. An example of the way one of these types of products worked was to offer a teaser interest rate adjustable rate mortgage (ARM), which would reset at a much higher rate after two or more years. The vast majority of these mortgages, often cash-out, were either refinanced into more attractive products or into another teaser ARM. This model of constant churning and refinancing only worked in a market that continued to show increased home price appreciation.

Private label loan issuance during the period starting in 2002 was also driven by investment banks looking for loans to securitize into ABS, including residential mortgages, commercial mortgages, commercial loans, and auto loans. Searching for yield, the international investment community invested in the mortgages and securities, which in turn fueled continued dollars funding the originators and issuers of these securities.

The deterioration of these securities in the housing crisis of 2008 concerned those drafting the Dodd-Frank Act. The authors of the credit risk retention provision were seeking to make sure that securitizers had some “skin in the game.” Knowing they would have to retain a portion of the securitized product they were selling, securitizers would have a vested interest in creating a money-making investment, so that investors could have some reassurance that the loans underlying the ABS were sound.

6 Consensus amongst policy analysts is the final rule will be issued before the end of Q1-2014.
QRM Equals QM (Option One of the Re-Proposal)

In the re-proposed CRR rule, the agencies offer two alternatives. The first alternative defines the requirements of a QRM to be the same as those of a QM, under the rule promulgated by the CFPB.8 By statutory language, QRM may be no broader than QM, and the law states that securitizers must retain “not less than 5 percent of the credit risk of any asset that is not a qualified residential mortgage.” Said another way, QRMs should be equal to or less risky than QMs and thus not require the securitizer to hold any capital against the transaction due to the unlikelihood of default on the underlying mortgages. Both the QM and QRM provisions attempt to inhibit imprudent underwriting and excessive risk taking, but the QM rule is meant to emphasize consumer protection while the QRM definition in CRR is focused on investors and a sound market.9 Sheila Bair, the former FDIC chairwoman and originally one of the most vocal proponents of risk-retention, described the rule as “reforming the ‘originate-to-distribute’ model for securitization and realigning the interests in structured finance.”10

Alignment of the QRM definition with the QM rule, with its eight underwriting factors for determining a borrower’s ability to repay (ATR), among other considerations, reduces possible confusion in the marketplace that could have arisen from differing definitions.11 As described in our earlier paper (“ATR/QM Standards: Foundation for a Sound Housing Market”), the rules promulgated by the CFPB were designed to result in sound mortgages in that the homeowners obtaining them had demonstrated to the lender an ability to repay the mortgage. Using the QM definition for a QRM for securitization purposes, the investor presumably is confident that the underlying collateral for the MBS that he or she is intending to purchase is a sound mortgage (or other consumer loan), and thereby the risk of the investment is reduced.

An analysis of mortgages originated in the 2005–2007 period shows that loans that qualify under the proposed QRM standards were sound and less prone to the delinquency found in many other mortgages made during that same period.12 As noted in the CRR rule re-proposal, of prime fixed-rate mortgages originated from 2009 to 2010 that comply with the QM definition, an estimated 1.4 percent experienced a 90-day or more delinquency or a foreclosure by the end of 2012.13 This compares to 16 percent of those originated from 2005 to 2008. However, the QM/QRM alignment can cause issues distinguishing cost pricing associated with QM “safe harbor” loans versus the rebuttable presumption of non-QM and the cost of capital for loans that fall outside of QRM (or non-QM). Though the costs may be different for rebuttable presumption and non-QRM capital requirements, the two risk factors will be directionally priced the same, as they would now be aligned.

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8 For more about QM, see the first article in the Foundation for a Sound Housing Market series, “ATR/QM Standards.”
9 Dodd-Frank specifically assigned the making of the QM definition to the CFPB, and assigned the CRR and QRM definitions to the banking agencies.
11 However, CFPB Director Richard Cordray raised concerns regarding the alignment of the two definitions: “In designing the QM standard, one of our goals was to assure that over the long-term, the QM parameters do not define the outer boundary of responsible lending but instead leave that determination to the market itself,” he said. “I’ve said repeatedly that lenders with strong underwriting models, particularly smaller lenders, should continue to have confidence in making the same kinds of loans they’ve already been making historically and that have performed well though the financial crisis whether they constitute QM or non-QM loans.” Former FDIC Chairwoman Sheila Bair also stated, “The QRM is the exception, not the rule, and as such, I believe it should be narrowly drawn.”
12 Rule proposal at 257.
13 Rule proposal at 258.
The Exemptions

The Dodd-Frank Act requires the agencies to prescribe regulations that:

(i) Require a securitizer to retain not less than 5 percent of the credit risk of any asset that the securitizer, through the issuance of an asset-backed security (ABS), transfers, sells, or conveys to a third party, and

(ii) Prohibit a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain under… the agencies' implementing rules.\(^{14}\)

The same provision of the Dodd-Frank Act exempts certain types of securitization transactions from the risk retention requirements, for example, MBS issued by government-sponsored enterprises (GSEs), including the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). It also provides that a securitizer is not required to retain any part of the credit risk "if all the assets that collateralize the ABS are qualified residential mortgages (QRMs), as that term is jointly defined by the agencies."\(^{15}\) It has been argued that this exemption reduces the liquidity benefits and risk profile of any pool size that could be realized by comingle QRM and non-QRM pools by the securitizer. Will any securitizer want to issue an MBS with a non-QRM pool of loans, or will the risk premium need to be so large that it will not make economic sense to create the security? These are reasonable questions that will be answered over time, with market acceptance of final QRM rules and implementation.

Investors will know that MBS with QRM are solid investments (based on the expectations of the ATR/QM rules, as written), all the more so because of the risk-retention criteria of the CRR rule. However, what remains to be seen is whether private label originators will issue non-QRM MBS. The agencies estimate the direct cost of funding the retained portion will be small, from zero to three basis points. Private industry estimates are often higher. But the cost of indirect compliance is harder to quantify, and may be much larger to ensure compliance to the rules.

Similar to QM, QRM offers broad exemption language to the Department of Housing and Urban Development (HUD) and the Federal Housing Finance Agency (FHFA), which may individually or jointly choose to adopt an exemption for any securitization transaction that they deem “appropriate in public interest and for the protection of investors.”\(^{16}\) However, QRM, unlike QM, does not provide a sunset on the power of exemption or adoption of such a measure. This provision allows for flexibility given the uncertainty surrounding the requirement of Congressional action to determine the future of the GSEs. But, it begs the question of whether the securitization market for mortgage loans will only offer MBS with QRM loans given the monetary disincentive to create MBS that are non-QRM.

\(^{14}\) Rule proposal at 15.
\(^{15}\) Rule proposal at 16.
\(^{16}\) See 15 USC 1639c, section 129C(b)(3)(B)(ii).
The QM Plus Alternative (Option Two of the Re-Proposal)

The joint re-proposal offers for comment an alternative to the primary option of harmonizing the QRM and QM definitions, the so-called QM Plus. This option would align QRM with QM’s eight core criteria and then layer on four additional requirements. In the Plus alternative, loans that fell under the “General QM” definition would meet the QRM standard, but loans that fall under the temporary exemptions of GSE-eligible, small creditor, or balloon loan exceptions would fall outside the bounds of QRM. Additionally, all QRMs would have to be one-to-four family principal dwellings, have no lien recording other than the mortgage in first position for purchase originations and the borrower could not be more than 30 days past due on any current credit obligation and 60 days past due on any debt obligation in the past two years. The borrower must not have been a debtor in bankruptcy, had a property repossessed or had a one-to-four family property foreclosed upon, or engaged in a short sale or deed-in-lieu of foreclosure. Finally, the QM Plus would reinstate a loan-to-value (LTV) threshold at 70 percent. The adoption of QM Plus could potentially exclude 65 percent of the originations made from Jan. 2013 to Aug. 2013 from being QRMs, not including streamline refinances. When including streamline refinances, 75 percent of the overall loan count of originations are removed from the narrower alternative approach of the QRM definition.

Private Investment and Jumbo Loans Considered

The private securitization market remains small compared to the oversized footprint of the agency securitization market but is growing. Private industry and government are aligned in expressing the need to reduce the government footprint in the housing market. In particular, FHFA acting director Ed DeMarco, representatives of the investor community and President Barack Obama agree that there should be more private capital at play in the system. The
GSE exemptions, though necessary until an agreed upon GSE transition plan is detailed, will continue to offer liquidity without the full necessity of having skin in the game (risk retention). Private capital and risk retention will need to compete with the current model, which will be based on further shifts in conforming loan limits or guarantee fees and uncertainty across the regulatory spectrum.

The exemptions provided by the CRR rule do not extend to so-called jumbo loans, that is, loans that do not meet the conventional conforming loan limits required by the GSEs for purchase. These loans are typically of high quality, but are generally charged a higher interest rate. Jumbo loans do not fall within the GSE exemption in QRM and QM, but regardless of loan size, a lender must comply with the ATR rules promulgated by the CFPB. While securitizers may want to default to the safe harbor provided by the QRM provision of the CRR rule, and keep non-QRM and jumbo loans out of their MBS, the ATR rule should be a back-up protection pointing to the safeness and soundness of the mortgage-backed investment.

As the country recovers from the financial crisis, interest rates have remained low. Based on the interest rate environment, the housing market and home building have begun to pick up again in certain markets. As has been validated time and again, housing is local and for some markets devastated by the crisis, the renewal is slow. While in some neighborhoods, empty homes remain a reminder of foreclosures resulting from the crisis, in other neighborhoods homes are being built with layouts of 10,000 square feet of space for a family of four and a separate garage with space for additional cars. Homes of this size are increasingly bought with cash, but more commonly, “jumbo” loans are obtained to fund the home purchase. Loans of this size are well documented, and down payments often significant. However, the loans are considered more risky, as the house may be difficult to sell given its size and price, and the smaller market of eligible buyers for that type of home. However, there is no reason to believe that jumbo loans will not be sound investments as part of a loan pool for an MBS.

There is a large amount of data available on home purchasers, including their credit and purchasing histories, and with the disclosure of their assets available as collateral, a data-driven analysis can assist in making sound decisions with respect to the loan being considered as part of a MBS. But the markets and investors are risk-averse, and while the exemption exists for the GSEs, it is conceivable that the risk potential will reduce the chances that jumbo loans will be part of private label MBS. Commentators currently are estimating that the cost of underwriting non-exempt QRM loans (the cost of capital) for banks and issuers may be so high as to discourage the issuance of this product, given that the loans are not backed by the government. The cost to comply with the CRR rule’s mandate for retention of 5 percent of the risk of the security is a cost the securitizer may choose not to bear.

Although still in proposal form, the CRR rule does make an effort to address the skin-in-the-game question raised after the financial crisis. But there is a universe of mortgage loans that will fall in the exempt bucket outside of the GSE limits established by the FHFA. Balance sheets and private label securities will need to fill in the blanks for those products that fall outside of the government footprint. It remains to be seen what the appetite, pricing, and structure will be for the private label market to create MBS for non-exempt securities. Many disparate groups would agree on the importance of attracting private capital to the housing market in order to have a fully functioning and rational marketplace. This next slate of rules developed for the safety and soundness of the financial system will inevitably assist with building a roadmap from government markets to the private path for investors. Certainty and clarity will guide us in 2014 and beyond.

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“This next slate of rules developed for the safety and soundness of the financial system will inevitably assist with building a roadmap from government markets to the private path for investors.”
Graphical data is from CoreLogic Loan Level Market Analytics contributory servicing database. Overall loan count includes GSE and private loans (balance sheet and PLS), the subset purposefully excludes FHA/VA. The loans are owner-occupied, residential, first-lien originations funded between Jan. 2013 – Aug. 2013 (Aug. contains partial data). Loans with missing parameters such as DTI, FICO and LTV were removed from the overall loan count.

QM Plus falls under the eight core criteria of the General QM definition. The cuts provided do not account for the 3 percent points and fees threshold, nor does it account for prepayment penalties. The multiple cuts allow for analysis with or without refinance programs that do not require full documentation and will fall beyond the bounds of QM upon the effective date. The temporary nature of some of these refinance programs should be considered when assessing the future normalized market. HARP is scheduled to expire on Dec. 31, 2015.

QM Plus loans cannot be “currently 30 days past due on any debt, not 60 days past due on any debt in the past 24 months, no bankruptcy or foreclosure in the past 36 months.” These analysis offer a range of FICO bands as a proxy for the specific credit data described above in the definition of QM Plus.
Margarita S. Brose:
Margarita S. Brose has more than 20 years of experience in the financial markets, first as a regulator with the Securities and Exchange Commission, and then as a management consultant with PricewaterhouseCoopers and IBM, where she focused on providing compliance and risk advisory services to her clients. Margarita was a director at Fannie Mae from 2006-2008, assisting with the company’s financial restatements, and most recently, was a director in the Operational Risk Management group at Barclays Investment Bank. She is the lead editor of the “Handbook of Financial Data and Risk Information” to be published by Cambridge University Press in December 2013. Margarita holds an MBA in strategic management from The Wharton School, a J.D. from The George Washington University Law School, and a B.A. in history from Barnard College.

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Faith is responsible for managing the CoreLogic government business, while providing policymaker education and thought leadership. Prior to joining CoreLogic she was an executive director at the HOPE NOW Alliance, a non-profit coalition created in 2007 to bring together, servicers, lenders, investors, Federal Reserve Banks and government-sponsored enterprises to help homeowners in distress stay in their homes.

Faith is a former member of the Federal Reserve Consumer Advisory Committee and currently sits on the boards of the CoreLogic Academic Research Council, the Structured Finance Industry Group (SFIG), and HOPE LoanPort, which provides a communication loan workout vehicle for borrowers, counselors, and investors. In 2013, Faith was honored by the MBA as one of the Top 20 Leading Industry Women and in 2012, was selected as one of HousingWire’s Women of Influence.

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