Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

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Agencies' QRM Proposal is a Step Forward*

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September, 2013

Regulators have released a proposal establishing standards for securitization in accord with the Dodd-Frank Act requirement that securitizers retain a share of the credit risk of each securitization. This proposal, once finalized, leaves only the harmonization of TILA and RESPA as the outstanding big ticket residential mortgage regulation still to be promulgated. There is a good chance, therefore, that there will be in place by the end of this year regulations intended to implement all of the major DFA sections with respect to that industry sector. This has been a massive undertaking and the regulations completed will need changes and additions in the months ahead, but the bulk of it will be done.

Positives

There are significant differences between the original risk retention proposal issued in 2011 and the present proposal. While some differences are more significant than others, taken together they present a regulation that will encourage lenders and securitizers to originate and securitize more mortgages than would have been originated and securitized under the earlier proposal. Here are a few of the reasons.

1. The need to keep a premium capture cash reserve account for each non-exempt securitization has been eliminated.

In many respects, this is the most significant of all of the changes in the proposal. The premium capture account would have captured 5 percent of the issue, not 5 percent of the credit risk of the issue. While the industry

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made its opposition to this feature known from the beginning, the regulators continued to evidence some support for the idea. Apparently, they no longer do, and that is a positive result for those seeking loans to buy houses in the U.S.

2. QRM will equal QM and there will be no down payment required.

In the new proposal, QRM has been defined as equivalent to QM (as that term is defined in sec. 129C of TILA), and as a part of that equivalency, the requirement that there be a down payment to obtain the QRM exemption from credit risk retention has been eliminated. The implications of those changes are profound. Commentators on the proposed rule made the point that a difference in these two definitions would complicate mortgage lending, and the requirement for a down payment would reduce the number of potential borrowers while particularly squeezing out low- and moderate-income borrowers.

While the proposal itself does not reference the legislative history, there is such history that supports the position opposed to including a down payment. (See the paper by Raymond Natter titled "What Was the Legislative History Behind the QRM?" in which Natter specifically addresses the issue of intent of the provision as expressed in the U.S. Senate debate on whether there should be a down payment requirement in the QRM definition.[1]

Senator Corker had proposed an amendment that would require a 5 percent down payment for QRM eligibility, and in leading the opposition (the Corker amendment was ultimately defeated), Senator Dodd, Chairman of the Senate Banking Committee and co-author of the Act bearing his name, said:

> The [Corker] amendment puts in government-dictated, hard-wired underwriting standards that would have very serious consequences, for first-time homebuyers, minority home buyers, and others who are seeking to attain the American dream of home ownership....

[1] ***Our Perspectives, June, 2011, Raymond Natter***

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> Many insured depositors (sic), of course, have mortgage programs that require less than 5 percent down payment. They are performing well, and have done so in the past. And we want low- and moderate-income families to go to banks and get loans, qualified low- and moderate-income people...We do not want to simply shut them off to nonprofits. We want to get them into the financial mainstream.[2]

Others, including Senator Merkley (who offered an amendment that required strict underwriting standards but included no down payment) voiced opposition, and the view of the Senate was reflected in the defeat of the Corker amendment and the adoption of the Merkley amendment.[3] While there were other provisions in both bills that influenced the vote, the down payment requirement in the Corker bill, and lack of one in the Merkley amendment was central to the decision.

3. A sunset would be created on the prohibition against hedging or transferring credit risk on certain performing loans.

In order to ensure that good underwriting practices are maintained, the original proposal prohibited the transfer of the credit risk through hedging or other means. This proposal recognizes that at some point, the quality of the specific credit no longer is determined by the original underwriting, but instead is determined by life events that can occur in unpredictable fashion. In recognition, the proposal terminates the restriction on the later of either (a) five years after the date of the closing of the securitization transaction, or (b) the date on which the total unpaid principal balance of the mortgages that collateralize the securitization is reduced to 25 percent of the unpaid balance; or in any case no later than 7 years after the date of the closing of the securitization transaction. This will free up some otherwise restricted liquidity for the residential lending market.

[2] Natter, p. 3.
[3] Natter pp. 3-4

4. Securitizers' share of credit risk will be calculated on a fair value calculation of the security rather than its par value.

The basic concern that led the regulators to consider adopting the premium capture account was that the securitizers could manipulate the transaction to avoid any retention of risk. In part, that was because the measurement of the retained risk was based upon par value of the shares. A few commentators suggested to the regulators that perhaps a less harmful solution would be to require the measurement to be based on fair value rather than par, thereby minimizing the opportunities for manipulation. That is what the regulators have done in this proposal, required that the share of risk be based upon fair value of the ABS interests in the issuing entity that are issued as part of the securitization transaction.

5. No servicing standards are included in the proposed rule.

In the original proposal, the agencies included requests for comments to the question of adding to the proposal a series of servicing standards. Those issues have not been raised in this proposal, nor is there any text in the proposed rule that would implement any national servicing standards.

6. No credit risk need be retained for "seasoned loans."

Loans that have existed for some time and have performed well do not present the same risk of default as new loans. The agencies adopted that conclusion, and have determined that no credit risk need be retained for seasoned loans that (a) have not been modified since origination, and (b) have not been delinquent for 30 days or more. They have defined seasoned loans to mean either (i) loans that have been outstanding and performing for the longer of five years or until the outstanding principal balance of the loan has been reduced to 25 percent of the original principal balance, or (ii) have been outstanding and performing for seven years.

Negatives

The revised proposal contains a few elements, however, that, if adopted in the final rule, would have a negative effect on the ability of lenders from all sectors obtaining mortgage credit. Here are two that are very serious.

1. An alternative to the QM exemption (called "QM plus") has been proposed for consideration.

If adopted, the commentary in the proposal says that "significantly fewer loans likely would qualify as a QRM." While the commentary does not go farther, if the correct assumption is that securitizers will be more apt to securitize loans that are QRM loans, then adopting QM plus will lead to fewer loans being securitized. Because of capital constraints, that will most likely mean that fewer loans will be originated.

QM plus would not treat loans meeting the Bureau's provisions for GSE eligible transactions, small creditor exceptions or balloon loan provisions as QRMs, nor would it cover loans for other than principal dwellings or first lien loans. Borrowers for QM plus loans may not have been 60 days delinquent during the previous 24 months, nor more than 30 days late at the time of closing, or have other specific evidence of poor credit history as delineated in the QM plus definition.

Most important, the loan to value rating (based on the lower of appraised value or contract price) could not exceed 70 percent. This is best translated to mean that the borrower would have to provide a 30 percent down payment; the language in the proposal is silent on the use of mortgage insurance to absorb some of the gap between loan amount and value.

This alternative presents in stark terms the dilemma faced by government officials in trying to deal with the causes of the last crisis as a means of directing future economic activity. Do they ensure that only really good loans will be made so that only really good loans can be securitized, thereby preventing the problems created by bad loans, or do they limit the restraints to ensure only that at least good loans will be made, thereby risking that upon occasion a bad loan will creep in and some risk for the economy will be presented? The corollary is that in the cautious case, many fewer consumers will get mortgage loans.

2. Blended pools of exempt and non-exempt loans are not permitted for RMBS.

Commentators have recognized and conveyed to the regulators that there may be trouble acquiring sufficient non-exempt loans to form pools within a reasonable period of time, thereby making them harder to securitize. To deal with that problem, they have recommended that the agencies permit blending loans of exempt and non-exempt loans of the same classes in pools, and the agencies have agreed to permit that, with appropriate proportional reduction in required risk retention. However, that permission has not extended to RMBS. Nevertheless, the regulators have asked specifically for comment on whether such an approach may be constructed where the underlying assets are residential mortgages, and makes specific reference to particular provisions in DFA to which commentators should address themselves.

It is difficult to see that the purposes of the Act will be diminished by commingling QRM and non-QRM loans in RMBS. The required risk retention will be maintained, albeit in these cases that will be so by being applied against only part of the pool. More important, it will ensure sufficient liquidity and rapid accumulation of loans into appropriate pools, thereby making the price of loans as modest as possible. All of the public policy arguments made for commingling for non-RMBS loans are appropriate for RMBS.

Summary

While the changes made in the proposal will lead to more loans made to more consumers, yet with a cautious underpinning of conservative underwriting required, there are potential changes to the proposal that would add to the usefulness of the rule.

For example, do not adopt the alternative proposal. That would eliminate a large sector of consumers from the ranks of potential homeowners, and extend the time when others could own their home. Second, establishing a sunset of four years on retention of credit risk seems like a reasonable change, as well as a determining that a loan is a seasoned loan if it has been performing unmodified for four years and met the other conditions in the proposal. Seven years seems unduly cautious. Finally, blending QRM and non-QRM in pools likewise seems to be good public policy in that it will provide greater liquidity to the residential mortgage market without diminishing risk retention.

Viewed more broadly, however, the changes made by the agencies working jointly seem to be a step forward, and to be both beneficial and desirable. They will make it possible for more consumers to obtain residential mortgage credit while still assuring that the loans originated will be of high quality.

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