Proposed Qualified Residential Mortgage and Risk Retention Rule: Net Impact Bad for Housing

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Summary

The Federal banking agencies joint notice of proposed rulemaking to implement the credit risk retention requirements required by Dodd-Frank is intended to encourage the creation of good loans and to protect the financial system against the creation of riskier loans. In defining the Qualified Residential Mortgage (QRM) and Qualified Mortgage (QM), regulators are specifying what they view to be a good loan and thereby eligible for securitization without risk retention. In the draft of the proposals, however, regulators make two key mistakes.

- The definition of QRM is too restrictive as it describes a risk-less loan rather than a low-risk loan. These restrictions eliminate far too many credit-worthy potential borrowers.
- The approach to risk retention is too easy to evade and is too simplistic with its two-size-fits-all approach.

If the QRM is enacted as drafted, it will irrevocably alter the demand for homeownership. House price appreciation will stall or decline. New home construction will remain curtailed and employment in construction and real estate will shrink. Homeownership will fall below the long-term average of 65% of U.S. households. In particular, minority households will be severely disadvantaged, as even during the easy credit era, only 49% of Black households and 50% of Hispanic households were owners. The net negative impact on housing will slow growth in the overall economy.

In combination with risk retention requirements, these regulations will position large banks and REITs to be the only entities able to profitably make and securitize loans. While some aspects will raise costs for banking entities, the five large banks will have the flexibility to optimize profits between portfolio and securitized lending. All smaller entities will be priced out of the industry, curtailing finance employment growth. Moreover, the proposed regulations will also fail to achieve two of the stated goals. Though private securitization may be revived, its size will be severely limited. The small size of the private securitization market will not allow the Federal Government to reduce its role without further impairing housing markets and related economic growth.

To be effective, the QRM must be broadened to allow for more borrowers to qualify and for more originators to participate in the market. Risk retention must be strengthened to allow the private market for securitizing good loans to reactivate and grow.

Qualified Residential Mortgage

History shows that no home loan is risk-free. It is possible, however, to create a prudent and low-risk loan if traditional tried-and-true structures are properly underwritten. The 30-year, fixed-rate mortgage and related conservative structures worked for more than 40 years. Homogenous, predictable mortgage creation is good business favorable to borrowers, originators and investors.

Traditional structures with low historical default performance include:

- 15 and 30 year-terms;
- Fixed principal and interest payments;
- Adjustable principal and interest payments with capped resets;
- Mortgage guaranty insurance (or other insurance or credit enhancement) obtained at the time of origination for loans with higher than 80% loan-to-value;
- Prohibitions/restrictions on balloon payments, negative amortization, pre-pay penalties, interest-only and other similar high-risk features;
- Prohibition against refinance to extract equity and addition of second liens.

Proper underwriting requires:

- Full appraisal;
- Documented and verified financial resources for the borrower;
- Standards for residual income after meeting all obligations; ratio of housing payment to income; and the ratio of all installment payments to income; and
- True appreciation of applicant's ability to enter into the responsibility of home ownership.

As defined in the Credit Risk Retention proposed rule, the QRM includes too many restrictions, but also misses important underwriting considerations.

- The definition of QRM requires a 20% down payment and excludes mortgage insurance. Each requirement individually is too restrictive. Combined, these restrictions would result in an exclusive mortgage market with credit available only for the wealthy.

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- Congressional legislators chose not to specify a down-payment requirement in asking regulators to define the QRM. They did choose, however, to specifically call for the use of mortgage insurance to ensure the access of reasonably priced mortgages to low and moderate income borrowers and first-time buyers. The legislators were also specifically aware that current owners with diminished equity will potentially be trapped without the availability of mortgage insurance. They recognized that the elimination of these key groups from the housing market would reduce the pace of home sales and have a dampening effect on house prices.
- Dodd-Frank specifies the goal of defining QRM taking in to consideration underwriting and product features that "historical loan performance data indicate result in a lower risk of default." Fifty-three Senators and more than 300 Representatives have responded to the proposed restrictions, declaring them to be overly restrictive beyond the intent of Congress. Letters from Capitol Hill emphasize that Dodd-Frank allowed for mortgage insurance.
- In their request for comment, the agencies specifically ask for data on loan performance with mortgage insurance, focused on the issue of whether or not having it in place reduces the risk of default. Such analysis has been undertaken by various parties and clearly shows that loans with mortgage insurance reduce the risk of default among similar, uninsured high LTV loans.[1] This is particularly true when comparing mortgage insured loans to first lien loans that had a simultaneous second lien ("piggybacks") in lieu of mortgage insurance, further reinforcing our view that there should be strict limitations on the use of second liens.
- If traditional structures are fully underwritten, the vast majority of borrowers will make timely payments throughout the life of the loan. The exceptions are circumstantial and include loss of job, illness, lack of health insurance, divorce and other events that disrupt the income verified in the underwriting process. Historical data shows the infrequency of such events in the performance of traditional, well-underwritten loans. If mortgage insurance is in place, it will cover losses should any of these events occur.
- In addition to the restrictive down-payment requirements, the proposed regulations require especially low front- and back-end debt-to-income standards.
- The definition also excludes borrowers with 60-day delinquencies within the previous 24 months. Given the range of problems associated with mortgage loans created in the 2003-2008 bubble period, we believe that not all delinquencies are the fault of the borrower. This restriction is unfair in light of recent mortgage practices and will limit mobility and move-up purchases.
- As each layer of these stringent requirements is applied, more and more credit-worthy borrowers are excluded. As an indication of the restrictiveness of the proposed QRM definition, according to the proposal, only 19.8% of loans guaranteed between 1997 and 2009 by Fannie Mae or Freddie Mac would qualify as QRMs. CoreLogic estimates that repeat buyers in states with high levels of underwater mortgages will be particularly affected because these buyers will not have enough equity to qualify; only 54% of homeowners with mortgages would qualify using the 20% down-payment requirement.
- At the same time that the QRM is overly restrictive, we find the proposal misses the mark when it comes to second liens. Although the proposal restricts the use of second liens at the time of origination, it does not restrict the addition of a second lien after origination. It is critical for regulators to curb the use of second liens and to ensure that investors can count on the lien priority order going forward. In the present crisis, debt service on second liens has been covered in lieu of first liens, and first liens have been foreclosed without the second being foreclosed. This skewing of contract law must be prevented in the future.

We favor some, but not all aspects of the alternative approach outlined in the Risk Retention Proposal.

- We agree that the options to reduce a borrower's required cash down-payment through the use of mortgage insurance or other types of third-party credit enhancement should be included in QRM guidelines. In addition to the FHA's low down-payment loans, the agencies and private lenders must be encouraged to underwrite 5% and 10% down-payment loans. The mortgage performance record shows that low-risk, 85%-97% loan-to-value loans can be made to fully underwritten borrowers with the income to make monthly interest and principal payments.
- Allowing a lower down-payment is the most critical element to ensuring access of mortgage credit to all credit-worthy households. The additional suggestions to increase DTI would also open mortgage credit to a wider pool of potential borrowers while still creating good loans. The most important restrictions are the ones in Dodd-Frank that exclude negative amortization, payment shocks, no-document lending and other weak underwriting features.
- It is critical, however, to restrict the use of subordinate liens at closing and during the life of the loan.

Risk Retention

There are two key problems with risk retention as defined in the proposal. The primary problem is the assessment of risk in mortgage portfolios is more nuanced than the two sizes proposed.

- The Dodd-Frank legislation provided for risk retention to be set at

1 Assessing the Delinquency and Default Risk of Insured and Non-Insured High LTV Mortgages, July 15, 2011, Promontory Financial Group, LLC.

levels appropriate to the risk of the instruments. The QRM was included to define loans with less risk. Five percent was set as a minimum, but legislators were careful to note that there were cases when risk retention should be lower and higher.

- The 5% risk retention is proposed to cover all mortgage structures outside of the QRM. While Dodd-Frank requires income verification for all loans and specifically requires lenders to determine if the borrower is capable of repaying all loans on any single dwelling, it allows the use of riskier structures including balloon payments, negative amortization and interest-only loans. The exact requirements for these loans would be set by the Consumer Financial Protection Bureau.
- Data show as each factor is added, the risk of default increases. If one or more of these risk factors are present, we would argue that it is likely that risk retention of greater than 5% would be required.

The second problem is that it is too easy to evade through the wide range of structuring options.

- Issuers are afforded a great deal of flexibility in selecting the 5% of risk they retain.
- The large banks, favored under the proposed regulations, are likely to serve as both originator and issuer. These banks will have the ability to cherry pick, keeping lower-risk loans on the books and securitizing higher-risk loans.
- Moreover, originators and issuers will be free to create instruments with levels of risk beyond what a 5% retained piece could cover if the loans went bad.
- A continuum of risk retention must be provided for so regulators are assured that the level of retention truly matches the level of risk.
- The Premium Capture Reserve Account, designed to prevent the upfront profit on securitization from negating the meaning of risk retention, may merely increase the cost of securitization and serve as a deterrent. Banks may opt to make and keep only low-risk loans.

The intent of Dodd-Frank is to prevent another crisis, while ensuring a liquid mortgage market. To be effective, the QRM must be broadened to allow for more borrowers to qualify and for more originators to participate in the market. Risk retention must be strengthened to allow the private market for securitizing good loans to reactivate and grow.

Biographies

Lewis S. Ranieri

Lewis S. Ranieri is the prime originator and founder of the Hyperion private equity funds ("Hyperion") and is a principal partner and founder of Selene Residential Mortgage Opportunity Fund. Prior to forming Hyperion in 1988, Mr. Ranieri had been Vice Chairman of Salomon Brothers, Inc. ("Salomon"). He is generally considered to be the "father" of the securitized mortgage market. Mr. Ranieri helped develop the capital markets as a source of funds for housing and commercial real estate, established Salomon's leadership position in the mortgage-backed securities area, and also led the effort to obtain federal legislation to support and build the market.

Kenneth T. Rosen

Ken Rosen is Chairman of Rosen Consulting Group, a real estate market research firm, and Chairman of the Fisher Center for Real Estate and Urban Economics and Professor Emeritus at the Haas School of Business at the University of California, Berkeley. Mr. Rosen is also the special real estate advisor to The Davos World Economic Forum. He was Chairman of Rosen Real Estate Securities. Mr. Rosen received his Ph.D. in Economics from the Massachusetts Institute of Technology in 1974 and a B.A. with highest honors from the University of Connecticut in 1970.

Andrea Lepcio

Andrea Lepcio, Principal, joined Rosen Consulting Group in 1997. She is based in New York and is responsible for business development and Eastern region client relations. Prior to joining RCG, Ms. Lepcio was Vice President and Head of Market & Investor Research at Chase Manhattan Bank. Before that, she was a founding member of the Real Estate Research group at Salomon Brothers. Ms. Lepcio earned a B.A. from the College of the Atlantic and an M.B.A. from the University of California, Berkeley.

Buck Collins

Buck Collins is the Senior Associate to Lewis S. Ranieri. Prior to joining Mr. Ranieri, Mr. Collins held a position as a consultant at Morgan Stanley in the Private Wealth Management division. A former member of the American Ballet Theater, Mr. Collins retired from his long standing career in 2006.

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