Can QM and QRM be Unified or Harmonized?*

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As a consensus starts to grow around the idea that qualified mortgage (QM) and qualified residential mortgage (QRM) should "be the same," it is time to consider if the statute permits that to happen. The Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA or Act) says that the agencies shall define QRM "to be no broader than the definition of 'qualified mortgage...'" That does not necessarily mean that they can be the same, but perhaps there is a smooth way to harmonize them.

The history of the two provisions

The colloquial history of the two provisions may be enlightening. In the House of Representatives, the initial effort was to see if an exception to ability to repay could be created for loans that everyone would agree were prime loans. Those were seen as loans of solid quality, and, therefore, could be provided protection from the severe penalties that were being considered for violations of ability to repay. Those potential penalties were to be reserved for non-prime loans. By their nature, prime loans reflected good underwriting, a good assessment of the ability of borrowers to repay loans, and had a track record of excellent repayment. The idea was to drive loan origination to prime loans and keep the securitization pipeline clean of bad non-prime loans.

There is some empirical data to support the argument that few loans, if any, will be made when violations of the rules surrounding the loans leads to penalties such as those in the ATR provisions. Home Ownership and Equity Protection Act (HOEPA) and Higher-Priced Mortgage Loan (HPML) loans

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both are subject to the same severe penalties that are attached to the ability to repay provisions. Very few HOEPA and HPML loans are made.

In 2010, less than one-tenth of one percent of the mortgage loans originated were HOPEA loans, and only 3.2 percent were HPML loans.[1] This is relevant because those loans have the same severe penalties that DFA attached to loans that failed to meet the ability to repay tests. It is those severe penalties that will cause lenders to establish systems that will ensure that they do not lend outside the protections of QM.[2]

As Congress was considering that approach, articles appeared that suggested that the real problem was that no one cared about the quality of the loans because they didn't retain any risk in the securitization process. Therefore, Congress should ensure that everyone had some "skin in the game."

Catch phrases catch on by definition, and this one did. The establishment of credit risk retention found a willing Congress, and that resulted in the QRM provisions. At the same time, work continued on trying to define good loans and giving them some protection from the need to demonstrate independently that the lender had correctly considered the ability of the borrower to repay the loan. That ultimately resulted in QM.

Had agreement been reached more quickly on the ability to repay exceptions, one could argue that there would have been no need to create credit risk retention since the penalties for originating loans outside the QM definition would have been so severe that only the most reckless originator would have made those loans. Protection against a repeat of the problems would have been strong without any credit risk retention. With the momentum

[1] Fed Res. Bull., Sept. 2011, Avery, Bhutta, Brevoort and Canner, "The Mortgage Market in September 2010: Highlights from the Data Report under HMDA." Fewer HPML loans likely will be made in the future because DFA amended the law to make it clear that the ability to repay penalties exist for violations of HPML laws. In addition, the market changed, and loans for manufactured housing (the major ingredient of HPML loans in 2010 loans) are now being financed by that industry.

[2] Predicting the size of the market when major changes such as QM occur is difficult, but some trade associations are attempting to do that research now. Early results are of slim samples, but show a decided drop in loans offered.

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that "skin in the game" had generated, however, that argument probably would not have prevented QRM from being established.

Purpose of each provision

The Act describes different classifications (QM and QRM), and while some of the elements within each definition are the same or similar, some differ. QM seems to describe tests to determine if a borrower has the ability to repay a loan — i.e., is there a balance between the borrower's expenses and his income such that he has the funds available to make the payments. If the tests are met, then the lender is deemed to have met the ability to repay test and should not be subject to the penalties for failure to meet them. QRM, on the other hand, seems to describe tests to determine if a borrower is inclined or has the propensity to repay a debt — i.e., does his history or the history of others in his situation predict that the borrower will make the payments in a timely fashion. If they do, there need be no credit risk retained on the sale of that loan.

For example, QRM requires that a loan-to-value ratio determined by the regulators must be met to qualify a loan as a QRM. There is no such loan-to-value (LTV) requirement in the definition of a Qualified Mortgage. An LTV test is not particularly relevant to the question of the ability of the borrower to repay the loan, but since it requires the borrower to embed some of its own equity in the collateral that it might lose if the loan is foreclosed, it is relevant to the propensity of the borrower to repay the loan.

Nevertheless, it should be noted that in the proposed rule for QRM, the agencies focused on the "quality" or the "credit quality" of the loans and did not make the distinction between the ability and the propensity to repay a loan.

Theoretically, it can be argued that the purpose of both of these sections in the Act was to ensure that bad loans would not be made. If a loan is a Qualified Mortgage it is a loan that the agency has concluded demonstrates that the borrower has the ability to repay. Reasonable people would say that the chances of default on that kind of loan are very slim. QRM rules

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approach it from a different perspective — if risk has to be retained on "risky" loans, lenders generally won't make risky loans because it will be considerably more costly, and that will drive lending toward good loans.

How to determine if QM and QRM tests can be the same

In the proposed QRM rule, the agencies have said that they "propose to incorporate the statutory QM standards, in addition to other requirements, into the QRM requirements and apply those standards strictly in setting the QRM requirements in order to ensure that, consistent with Congress' directive, the definition of a QRM be no broader than a QM."[3]

That clarifies, for example, that the debt-to-income tests should be close to identical in each rule, as perhaps will other tests that are in both rules, such as the duration of the loan; negative amortization; deferral of interest or repayment of principal; balloon payments; limitations on increase of interest rate; prepayment penalties; points and fees; verification and documentation of income; and amortization of payments. While the interpretation of this statement by the agencies is not clear, it may mean also that the agencies will include in the QRM requirements QM elements that are not discussed in the sections creating QRM (such elements as employment status, payments on simultaneous loans, and the consumer's credit history).

Many of the elements of the QRM test, however, are not QM standards. For example, a QRM loan must meet an LTV test; a down payment test; a full appraisal; restrictions on assumability; limitations on past due history; restrictions on foreclosures, deeds-in-lieu, or short sales or repossessed personal property; be subject to servicing principles; be a first lien; and be on property that is the principal dwelling of the borrower. These are not standards for QM qualification.

There are various ways to judge the significance of those QRM-only elements. One could say that since they were not included in QM, their existence does not impact the coverage that QM has established. Another appropriate way would consider whether requiring a loan to meet those tests

[3] Vol. 76 Fed. Reg. p. 24090, 24118 (April 29, 2011).

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would expand the definition of QM. If it did not, they could exist without violating the rule that QRM should not be broader than QM.

It is clear, however, that on the surface some rules would have to be put in place to address those QRM provisions, notwithstanding that the purposes of QRM are in the main met by adherence to the standards of QM. Therefore, it is fairly clear that QRM and QM cannot be identical.[4]

Are there viable alternatives to unifying the two provisions?

In its discussion of its proposed QRM rule, the agencies pointed out that they were trying to encourage the creation of a private secondary market with the standards they were setting:

> The amount of non-QRM residential mortgages should be sufficiently large, and include enough prudently underwritten loans, so that ABS backed by non-QRM residential mortgages may be routinely issued and purchased by a wide variety of investors. As a result, the market for such securities should be relatively liquid, all else being equal. Indeed, the broader the definition of a QRM, the less liquid the market ordinarily would be for residential mortgages falling outside the QRM definition[5]

If the standards for QM are adopted verbatim for QRM, the major standards that will differentiate the QRM/non-QRM market will be standards such as LTV. QRM loans will meet QM standards and no loans will be made that exceed those standards. However, even if a loan meets the QRM/QM standards that doesn't qualify them as a QRM loan; they still must meet the other QRM standards not included in QM.

[4]However, Sec. 1412 of DFA amends TILA sec. 129C(b)(3)(B)(i) to say that the Bureau may add (or revise or subtract) to the criteria that define QM with a finding that "such regulations are necessary or proper to ensure that responsible, affordable mortgage credit remains available to consumers in a manner consistent with the purposes of this section and section 129(B), to prevent circumvention or evasion thereof, or to facilitate compliance with such sections." And see foot note 8 forward.

[5]Vol. 76 Fed. Reg. p. 24090, p. 24118 (April 29, 2011).

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Mortgages that met all other standards but do not meet the QRM LTV ratios will be in the non-QRM market and can be securitized by the private market, albeit with some risk retention. Will that be enough to create a secondary market? That is not clear.

Of course, the agencies do have the authority to vary the amount of risk retention needed.[6] They could perhaps reduce risk retention on those mortgages that met the standards of QM, regardless of whether they met the additional QRM standards, while maintaining the normal risk retention on those loans that failed to meet the QM standards.

Assume, for example, that the LTV standard adopted by the agencies for establishing a QRM loan was 80 percent. Assume further that a mortgage met the tests of both the QM standards and the additional QRM standards, including LTV of 80 percent. No credit risk would have to be retained on that mortgage.

Assume in a second case that the mortgage failed to meet the QM standards and the additional QRM standards. That mortgage would have to hold the regular 5 percent credit risk as outlined in the proposed rule.

Assume in a third case that the mortgage met the QM standards but had an LTV ratio of 95 percent.[7] The agencies could require less risk to be held against that loan, perhaps zero or some amount such as 1 percent. Such an exemption would meet the statutory requirements that say:

> Any exemption, exception or adjustment adopted ... by the... agencies... shall —
>
> (A) help ensure high quality underwriting standards for the securitizers and originators of assets that are securitized...; and
>
> (B) encourage appropriate risk management practices by the securitizers and originators of assets, improve the access of con-

[6] See, e.g., Section 15G(e) of the Securities Exchange Act of 1934.

[7] One could similarly differentiate based on principal dwelling first liens credit performance, and particularly in this environment, mortgage modification or foreclosure alternative programs.

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> sumers and businesses to credit on reasonable terms, or otherwise be in the public interest and for the protection of investors.[8]

A good case can be made that any loan that meets the QM standards does not present major risk of default. Differentiating between the amount of risk retention so that loans of that quality need retain only a very small credit risk (if any) would encourage lenders to originate loans that met the QM standards. In addition, it would provide the possibility of a private secondary market developing in loans of LTVs higher than (in our case) 20 percent and would provide credit to a number of borrowers who had the ability to repay the loan at a reasonable rate, although perhaps not quite so great as those who put more of their own equity into the purchase.

Conclusion

It is fairly clear that there cannot be a complete unification of QM and QRM standards. But QRM loan standards will in great part very closely mimic QM standards. Since that by itself will produce high quality loans, the agencies should feel free to reduce substantially the QRM risk retention requirements for those loans that meet those standards but fail to meet one or more of the additional QRM standards. That would harmonize the two rules and perhaps provide enough space in the market for a private market to develop on non-QRM loans that met QM standards.

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[8]Section 15G(e)(2) of the Securities and Exchange Act of 1934.

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