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

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Risk Retention is Unnecessary When Loan is a Qualified Mortgage*

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The Consumer Financial Protection Bureau has now published its final rules on the Ability to Repay rules mandated by the Dodd-Frank Act. Those rules become effective January 10, 2014.[1] Six agencies[2] have been working on rules which would implement Section 941 of DFA and require securitizers to retain a portion of the credit risk on residential mortgage loans they sell to third parties. They have no statutory deadline, but they did say that they would not finalize their rules until the CFPB had finalized the Ability to Repay rules. Now that those rules are finalized,[3] the expectation is that the six agencies will soon publish final rules on risk retention.

In the Ability to Repay rules, the Bureau has promulgated a Safe Harbor for loans that are Qualified Mortgages, and have defined the standards that are required to become a QM. In the risk retention sections of DFA, the agencies are directed to define mortgages that meet certain standards as Qualified Residential Mortgages, and to exempt those QRM loans from the risk retention requirements. The statute also says that the QRM definition can be "no broader" than the definition of QM.

Many are now suggesting to the agencies working on finalizing the QRM definition that in fact the definitions of QRM and QM should be the same. This may just be colloquial language use, since the elements that comprise the standards for QM do not fully overlap with the elements that are found

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[1]The questions concerning the constitutionality of the recess appointment of Director Cordray could create answers that might muddy the validity of those rules, the date on which they might become effective, and whether section 1411 of DFA is now the operative law.

[2]Federal Reserve, OCC, FDIC, HUD, SEC and FHFA.

[3]The Bureau has proposed a few rules that might make modest changes in the ATR rules; comments are due on that proposal on February 25, 2013.

in the proposed rules or in the statute comprising the guidelines for the QRM definition.[4]

There is another way to view the issue, however. If a loan meets the standards of a Qualified Mortgage, then there need be no credit risk retention required.

The purpose of both rules is to eliminate the origination of bad loans. In one case — QM — the statutory idea was to require rigid underwriting rules. In the other — QRM — the idea was to force originators to assume the credit risk on the belief that doing so would eliminate origination of bad loans.

The final rule establishing the standards for a Qualified Mortgage is based on the belief of the Bureau that such loans have only minimal risk of defaulting. For many of the QM loans, the Bureau has provided a Safe Harbor, which, if the standards for the Safe Harbor loans are met, will drastically limit the amount of successful litigation that can be brought alleging a failure to take into account the ability of the borrower to repay the loan. Other Qualified Mortgages will get the more limited protection of a rebuttable presumption of compliance with the ability to repay test. Non-QMs will not receive either a Safe Harbor or rebuttable presumption, and will be exposed to a dramatic set of penalties which are sufficiently severe that few lenders will make more than a nominal number of such loans. It should be noted that for up to the next 7 years, certain loans eligible for certain government insured or guaranteed loan programs or for GSE purchase will also be exempt from the penalties as being in effect a special set of Qualified Mortgages.

Based on the severity of the penalties that may be imposed for a violation of the Ability to Repay rules, most lenders will not originate non-QM loans. The risk of litigation and the potential costs of such litigation demand that approach.

Similarly, the credit risk passed on to third parties on loans that are QM loans is minimal. The Bureau has said, in effect, if the standards for QM are met, then the lender has made a reasonable determination that the borrower has the ability to repay the loan.

[4]See, "***Our Perspectives***," April 2012.

If that is the case, what additional protection against origination of poorly underwritten loans can be generated by the rules in QRM? If none, or effectively none, then consumers will be less confused and lenders will have fewer compliance problems if the QRM rule were to say — simply — if a loan meets the standards of a Qualified Mortgage, it will not be subject to retention of credit risk.

Section 941 of DFA says that no credit risk need be retained if the loan is a QRM, and that a QRM shall be defined in ways that result in a lower risk of default. Certainly it is fair to say that a loan that meets the very rigorous standards established by the Bureau is a loan that meets standards designed to result in a lower risk of default. In fact, it is likely that a very high proportion of all residential loans will meet those standards, or for the next 7 years, the standards of the various government agencies or the GSEs. In other words, the establishment of a rigorous QM standard has done what both the QM provisions and the QRM provisions (albeit in different ways) were designed and intended to do — avoid the origination of mortgage loans that borrowers cannot repay.

The credit risk in QM loans is modest. The risk of default of a loan underwritten to a DTI of 43 percent with verified income, no neg am, and meeting the other standards of a QM loan are very slim. In fact, if anything, they are so slim that there is a lingering risk that limiting loans to those standards will negatively impact the housing market beyond the contraction that the framers of the legislation wanted.

The QRM provisions in the proposed rule also require that there be certain loan to value ratios and down payments, provisions that are not found in the QM rules. Such limitations on loans might reduce defaults, but the level of defaults already reached by adherence to the QM standards will be sufficiently low. Additional rules directed to the question of whether the borrower will repay make sense if there are not rigid underwriting standards; they make little sense when rigid underwriting standards are in place as in the QM rules.

There is an advantage in making standards as uncomplicated as possible while still achieving the intention of the rule. The intention of both the QM rules and the QRM rules is to ensure that borrowers have the ability to repay loans that are originated, and that "bad" loans are not passed on to third parties in securitizations. If that can be accomplished by using the

same standard for exemption from the penalties in two complimentary rules, that would be a desirable result.

In this case, that result can be obtained by concluding that the loans that meet the standards set in QM need not retain credit risk under the risk retention rules.

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