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PROPOSED QUALIFIED RESIDENTIAL MORTGAGE  
DEFINITION HARMS CREDITWORTHY BORROWERS  
WHILE FRUSTRATING HOUSING RECOVERY

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# Proposed Qualified Residential Mortgage Definition Harms Creditworthy Borrowers While Frustrating Housing Recovery

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# Proposed QRM Harms Creditworthy Borrowers While Frustrating Housing Recovery

## Summary

As part of the financial reform legislation, Congress designed a clear framework for improving the quality of mortgage lending and restoring private capital to the housing market. To discourage excessive risk taking, Congress required securitizers to retain five percent of the credit risk on loans packaged and sold as mortgage securities. However, because across-the-board risk retention would impose significant costs on responsible, creditworthy borrowers, legislators also created an exemption for “Qualified Residential Mortgages,” defined to include mortgages with product features and sound underwriting standards that have been proven to reduce default.<sup>1</sup>

Congressional objectives would not be served if the good loans the legislation seeks to encourage were inaccessible to many creditworthy borrowers. Thus, Congress directed the regulators to balance the need for credit standards against the need to improve access to credit, providing that exemptions from the risk retention rules shall “... improve the access of consumers and businesses to credit on reasonable terms, or otherwise be in the public interest and for the protection of investors.”<sup>2</sup>

Unfortunately, regulators have drafted proposed Qualified Residential Mortgage (QRM) rules that upset the important balance contemplated by Congress. Rather than creating a system of penalties to discourage bad lending *and* incentives for appropriate lending, regulators have developed a rule that is too narrowly drawn. Of particular concern are the provisions of the proposal mandating high down payments. Other aspects of the proposal – such as the proposed debt-to-income ratios and credit standards – will also raise unnecessary barriers for creditworthy borrowers seeking the lower rates and preferred product features of the QRM.

The proposed QRM exemption requires a high down payment – proposed at 10 or 20 percent, with even higher levels of minimum equity required for refinancing – **despite the fact that Congress considered and rejected establishing minimum down payments precisely because these loans have been shown to perform well when accompanied by strong underwriting and safe, stable product features. In fact, the three sponsors of the QRM provision have sent letters to the regulators saying that they intentionally did not include down payment requirements in the QRM.**<sup>3</sup>

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<sup>1</sup> The statutory framework for the QRM requires the regulators to evaluate underwriting and product features that historical data indicate result in lower risk of default, including: documentation requirements; monthly payment-to-income standards; payment shock protections; restrictions or prohibitions on negative amortization, interest-only and other risky features; and mortgage insurance coverage or other credit enhancements obtained at origination to the extent they reduce default risk.

<sup>2</sup> Section 15G(e)(2)(B) of the Securities and Exchange Act of 1934 (15 U.S.C. 78(a) et. seq.), as added by Section 941(b) of the Dodd-Frank Act.

<sup>3</sup> See, for example, February 16, 2011 letter from Senators Landrieu, Hagan and Isakson to the QRM regulators stating “although there was discussion about whether the QRM should have a minimum down payment, in negotiations during the drafting of our provision, we intentionally omitted such a requirement.” Emphasis added. See also February 16, 2011 op

Requiring down payments of 10 or 20 percent is deemed by some as “getting back to basics.” However, well-underwritten low down payment home loans have been a significant and safe part of the mortgage finance system for decades. The proposed QRM exemption ignores these data and imposes minimum down payments of 10 or 20 percent, and equity requirements for refinancing borrowers of 25 percent or 30 percent.

As a result, responsible consumers who maintain good credit and seek safe loan products will be forced into more expensive mortgages under the terms of the proposed rule simply because they do not have 10 or 20 percent in down payment or even more equity for refinancing. These mortgages will be more expensive for consumers because the capital and other costs of retaining risk will be passed onto them, if the private market chooses to offer loans outside of the QRM standard at all. **In other words, the proposal unfortunately penalizes qualified, low-risk borrowers.**

The QRM should be redesigned to align with Congressional intent: **encourage sound lending behaviors that reduce future defaults without harming responsible borrowers and lenders.** With respect to credit availability for high loan-to-value lending, the statute specifically recommends that the regulators consider for eligibility for the QRM standard, loans that are covered at the time of origination by mortgage insurance or other credit enhancements, to the extent these protections reduce the risk of default. The Congressional mandate to craft exemptions from risk retention to “improve access to credit on reasonable terms” calls for a QRM definition that makes QRM loans accessible to a broad range of borrowers, without exclusions based on down payment or other unduly restrictive criteria.

### **Consumer Impact of Proposed QRM**

By imposing excessively high down payment standards regulators are denying millions of responsible borrowers access to the lowest rate loans with the safest loan features. The only beneficiaries of the proposed QRM definition are those consumers with higher incomes who can afford to make large down payments or who already have ample equity in their homes.

Based on the most recent available data on income, home prices, and savings rates, it would take 9.5 years for the typical American family to save enough money for a 10 percent down payment, and fully 16 years to save for a 20 percent down payment (Table 1), assuming that the family directs *every penny* of savings toward a down payment, and nothing for their children’s education, retirement, or a “rainy day.” Families saving for these other necessities will have to wait much longer. For example, a median income family that sets aside \$1000 per year of its savings for college tuition or retirement would need nearly 9 years to save for even a 3.5 percent down payment.

A 10 or 20 percent down payment requirement for the QRM means that even the most creditworthy and diligent first-time homebuyer cannot qualify for the lowest rates and safest products in the market. Even 10 percent down payments create significant barriers for borrowers, especially in higher cost markets (See Attachment 1). This will significantly delay or deter aspirations for home ownership, or require first-time buyers to seek government-guaranteed loan programs or enter the non-QRM market, with higher interest rates and potentially riskier product features without adding a commensurately greater degree of sustainability overall.

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ed by Sen. Isakson in [The Hill](#): “In fact, we debated and specifically rejected a minimum down payment standard for the Qualified Residential Mortgage.”

**Table 1**  
**Years for Median Income Family to Save for Down Payment**  
**(Assuming all savings are directed toward home purchase)**

	20% Down Payment	10% Down Payment	5% Down Payment	3.5% Down Payment
2010 Median Sales Price	\$172,900	\$172,900	\$172,900	\$172,900
Down payment + Closing Costs (est. @ 5% of loan amount)	\$41,496	\$25,071	\$16,858	\$14,394
# of Years Needed to Save @ National Savings Rate (5.2% of gross household income = \$2,625 per year)	16 years	9.5 years	6.5 years	5.5 years

Sources: Home Sales Price: NAR 2010 median sales price for condos and single-family homes. Household Income: NAR estimate of 2010 median before-tax household income (\$50,474). Personal Savings Rate: Estimated as a percentage of gross income based on 2010 data from the Bureau of Economic Analysis, *Personal Income and Outlays*. These figures are conservative because they assume 100% of family savings are dedicated towards a down payment and closing costs.

Minority households will be particularly hard hit by the proposed narrow QRM standard. As highlighted in a recent paper by Lewis Ranieri and Ken Rosen, these families already have significantly lower before tax family incomes and net worth than white households, which translate into sharply lower homeownership rates.<sup>4</sup> Ranieri and Rosen note that current underwriting standards are already unduly restrictive, and that private capital, along with the GSEs and FHA, should be “encouraged to return to active lending for all creditworthy borrowers.” Unfortunately, the proposed QRM cuts sharply against this important recommendation.

The impact of the proposed rule on existing homeowners is also harmful. Based on data from CoreLogic Inc., nearly 25 million current homeowners would be denied access to a lower rate QRM to refinance their home because they do not currently have 25 percent equity in their homes (Table 2). Many of these borrowers have paid their mortgages on time for years, only to see their equity eroded by a housing crash and the severe recession. Even with a 5 percent minimum equity standard, almost 14 million existing homeowners – many undoubtedly with solid credit records – will be unable to obtain a QRM. In short, the proposed rule moves creditworthy, responsible homeowners into the higher cost non-QRM market.

<sup>4</sup> Plan B, A Comprehensive Approach to Moving Housing, Households and the Economy Forward; April 4, 2011, by Lewis Ranieri, Ken Rosen, Andrea Lepcio and Buck Collins. Figure 14 shows that minority households in 2007 had median before tax family income of about \$37,000, compared to about \$52,000 for white families. Similarly, Figure 15 shows minority family net worth in 2007 of almost \$30,000, compared to more than \$170,000 for white families.

**Table 2**  
**Equity Position of U.S. Homeowners with Mortgages**

<b>47.9 million U.S. homeowners with mortgages:</b>	<b>30% equity</b>	<b>25% equity</b>	<b>20% equity</b>	<b>10% equity</b>	<b>5% equity</b>
<b># with less than...</b>	27.5 million	24.8 million	21.9 million	16.3 million	13.5 million
<b>% with less than...</b>	57%	52%	46%	34%	28%

Source: Community Mortgage Banking Project; based on data from CoreLogic Inc.

As now narrowly drawn, the QRM rule ignores compelling data that demonstrate that sound underwriting and product features, like documentation of income and type of mortgage, have a larger impact on reducing default rates than high-down payments.

A further analysis of data from CoreLogic Inc.<sup>5</sup> on loans originated between 2002 and 2008 shows that **boosting down payments in 5 percent increments has only a negligible impact on default rates, but it significantly reduces the pool of borrowers that would be eligible for the QRM standard.** Table 3 and Attachment 2 show the default performance of a sample QRM based on the following attributes of loans: Fully documented income and assets; fixed-rate or 7 year or greater ARMs; no negative amortization; no interest only loans; no balloon payments; 41percent total debt-to-income ratio; mortgage insurance on loans with 80 percent or greater loan-to-value ratios; and maturities no greater than 30 years. These QRM criteria were applied to more than 20 million loans originated between 2002 and 2008, and default performance is measured by origination year through the end of 2010.

As shown in Table 3 (and in Attachment 2), moving from a 5 percent to a 10 percent down payment requirement *on loans that already meet the defined QRM standard* reduces the overall default experience by an average of only two- or three-tenths of one percent for each cohort year. However, the increase in the minimum down payment from 5 percent to 10 percent would eliminate from 7 to 15 percent of borrowers from qualifying for a lower rate QRM loan. Increasing the minimum down payment even further to 20 percent, as proposed in the QRM rule, would amplify this disparity, knocking 17 to 28 percent of borrowers out of QRM eligibility, with only small improvement in default performance of about eight-tenths of one percent on average. This lopsided result compromises the intent of the QRM provision in Dodd-Frank, which is to assure clear alignment of interests between consumers, creditors and investors without imposing unreasonable barriers to financing of sustainable mortgages.

Importantly, this analysis takes into account the impact on the performance of the entire cohort of defined QRMs that would result from moving from a 5 percent minimum down payment requirement on QRMs in that cohort, to a 10 percent and a 20 percent minimum down payment requirement. As such, it shows the *broad market impact* of a QRM with a 5 percent down payment requirement compared to a QRM with a 10 percent or 20 percent down payment requirement, rather than simply

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<sup>5</sup> Source: Vertical Capital Solutions of New York, an independent valuation and advisory firm, conducted this analysis using loan performance data maintained by First American CoreLogic, Inc. on over 30 million mortgages originated between 2002 and 2008.



comparing default risk on 5 percent down loans to 20 percent down loans. Clearly, moving to higher down payments has a minor impact on default rates market-wide, but a major adverse impact on access by creditworthy borrowers to the lower rates and safe product features of the QRM.

**Table 3**  
**QRM: Impact of Raising Down Payments Requirements**  
**on Default Rates and Borrower Eligibility**

<b>Origination Year</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>
Reduction in default rate* by increasing QRM down payment <b>from 5% to 10%</b>	0.2%	0.1%	0.3%	0.3%	0.2%	0.5%	0.2%
Proportion of borrowers <b>not eligible</b> for QRM at 10% Down	7.6%	6.6%	9.0%	8.4%	10.9%	14.7%	8.4%
Reduction in default rate* by increasing QRM down payment <b>from 5% to 20%</b>	0.6%	0.3%	0.7%	0.8%	0.8%	1.6%	0.6%
Proportion of borrowers <b>not eligible</b> for QRM at 20% Down	19.2%	16.7%	23.0%	22.9%	25.2%	28.2%	20.7%

\* Default = 90 or more days delinquent, plus in process of foreclosure, plus loans foreclosed.

Source: Data from CoreLogic, Inc. Analysis by Vertical Capital Solutions for Genworth Financial and the Community Mortgage Banking Project.

### **Housing Market Impact of Proposed QRM**

Strong and sustainable national economic growth will depend on creating the right conditions needed for a housing recovery. The high minimum down payment/equity requirements and other narrow provisions of the proposed QRM will impair the ability of millions of households to qualify for low-cost financing, and could frustrate efforts to stabilize the housing market. To date, regulators have not provided an estimate of the cost of risk retention to the consumer. This should be done before finalizing any rule that could have such a significant adverse impact.

The regulators have informally suggested that risk retention will result in “only” a 10 to 15 basis point increase in rates for non-QRMs compared to exempt QRMs (although no methodology for this estimate is provided).<sup>6</sup> However, most private estimates of the cost of risk retention on non-QRMs are several orders of magnitude higher.

For example, a National Association of REALTORS® (NAR) analysis indicates a much higher cost of risk retention than the regulators’ calculations. According to NAR (see Chart 1), risk retention could raise rates for non-QRMs – the predominant product in the market under the proposed rule – by as much as 80 to 185 basis points. Similarly, a June 20, 2011 analysis by Mark Zandi of Moody’s Analytics estimates “conservatively” that borrowers of non-QRM mortgages would be saddled with interest rates 75-100 basis points higher than QRM-eligible borrowers.<sup>7</sup> In other words, today’s 4.5 percent contract rate for a 30-year fixed-rate loan that did not meet the QRM requirements would

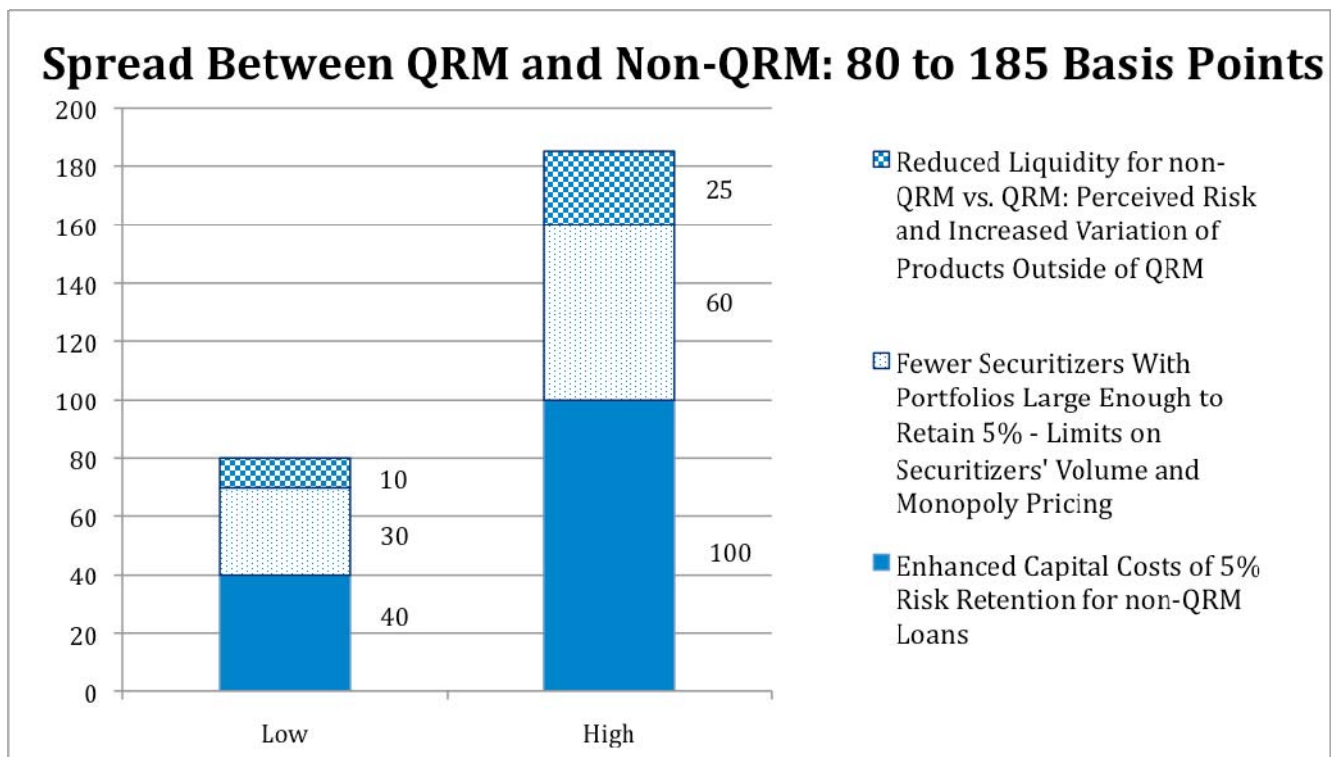
<sup>6</sup> “FDIC’s Bair Would Rather Eliminate QRM From Risk Retention Rule,” American Banker, June 10, 2011.

<sup>7</sup> Mark Zandi and Cristian deRitis, Moody’s Analytics Special Report, “Reworking Risk Retention,” June 20, 2011.

become a 5.25 percent rate, at best, and could go as high as 6.35 percent based on these estimated ranges.

A one-percentage point increase in interest rates could be devastating to a fragile housing market. According to estimates from the National Association of Home Builders, every 1 percentage point increase in mortgage rates (e.g., from 4.5 percent to 5.5 percent) means that 4 million households would no longer be able to qualify for the median-priced home. In terms of actual housing activity, the Zandi analysis translates this impact as follows: "... a 100-basis point increase in 30-year fixed mortgage rates reduces the pace of new- and existing-home sales by nearly 425,000 units per year, lowers median existing-house prices by 8.5%, and drops the homeownership rate by a full percentage point. Moreover, any increase in rates that results from broad application of risk retention to most borrowers would be *in addition to* a general increase in interest rates forecast by most economists over the next 12-18 months.

Chart 1



Source: NAR estimates. See <http://economistsoutlook.blogs.realtor.org/2011/06/17/qrm-higher-mortgage-rates-on-the-horizon/> for additional details.

The impact of the proposed definition of QRM would not be as severe as outlined here, since many borrowers would obtain exempt FHA loans or, until the GSE loan exemption is removed, GSE loans. However, these substitutions run contrary to the objectives of policy makers seeking to restore private capital and reduce dependence on federal guarantees in the mortgage market (as noted in more detail in the next section). As a result, when policies designed to shrink the FHA and GSE footprint are implemented, the full adverse effects outlined here of the narrow QRM will be felt.

For those markets already hardest hit by the housing crisis, the proposed narrow QRM definition will exacerbate conditions. For example, the five states most adversely impacted by the proposed QRM rule are Nevada, Arizona, Georgia, Florida and Michigan (see Table 4). As a result of price declines



already suffered in these states, at least two out of three homeowners do not have at least 25 percent equity in their homes that would allow them to refinance with lower rate QRM. Six out of ten would not be able to move and put 20 percent down on their next home.

For those borrowers that have already put significant “skin in the game” through down payments and years of timely mortgage payments, only to see their equity eroded by the housing collapse, the proposed QRM definition tells them they are not “gold standard” borrowers and they will have to pay more. In effect, **the proposed QRM would penalize families who have played by the rules, scraped each month to pay their bills, kept their credit clean, and saved for a modest down payment.**

**Table 4**  
**Proportion of Existing Homeowners that Do Not Meet QRM Equity Requirements**  
**Top 5 States with Highest Percentages**

State:	Proportion of homeowners with less than <b>30% equity</b>	...less than <b>25% equity</b>	... less than <b>20% equity</b>
Nevada	85%	83%	80%
Arizona	75%	72%	68%
Georgia	71%	65%	59%
Florida	70%	66%	63%
Michigan	68%	64%	59%

Source: Community Mortgage Banking Project, data from CoreLogic Inc.

With major regional housing markets ineligible for lower cost QRMs under the proposed rule, many states and metropolitan areas that have seen the sharpest price declines will face higher interest rates, reduced investor liquidity, and fewer originators able or willing to compete for their business. These areas face long-term consignment to the non-QRM segment of the market.

**It is important to emphasize that the adverse impact of the proposed narrow QRM is entirely unnecessary.** Well-underwritten low-down payment loans can and should play an essential role in a sustained housing recovery. As Zandi noted in a prior report on the QRM issue, “low down payment mortgages that are well underwritten have historically experienced manageable default rates, even under significant economic or market stress.”<sup>8</sup> In his recent paper on the proposed rule, Zandi concludes, “The risk-retention rules being proposed are unlikely to meaningfully improve securitization’s incentive problem. At the same time, they will raise borrowing costs significantly for many homebuyers and make loans difficult to get for others.”<sup>9</sup>

### **Market Structure**

The proposed narrow QRM rule discourages development of a renewed, robust and diversified private lending market. Under the restrictive QRM rule, the vast majority of loans will be non-QRMs subject to the higher costs of risk retention, yet it is not clear whether investors will view risk retention as

<sup>8</sup> Moody’s Analytics Special Report, “The Skinny on Skin in the Game,” March 8, 2011, by Mark Zandi (page 3).

<sup>9</sup> “Reworking Risk Retention,” June 20, 2011, page 1.

providing sufficient protection that would encourage them to invest significantly in non-QRM mortgage securities.

Moreover, with a statutory exemption for FHA and VA, government-backed loans will have a significant market advantage over fully private loans. As a result, the proposed rule will delay, or even halt, the return of fully private capital back into the market. This is contrary to the purpose of the QRM. Mortgage securitization pioneer Lew Ranieri has strongly supported efforts to reform the securitization process and improve the incentive structures in the market, but in response to the proposed rule, Ranieri has said: “The proposed very narrow QRM definition will allow very few potential homeowners to qualify. As a result, it will complicate the withdrawal of the Government’s guarantee of the mortgage market. I fear it will also delay the establishment of broad investor confidence necessary for the re-establishment of the RMBS market.”<sup>10</sup>

Although the treatment of the GSEs in the proposed rule mitigates the immediate adverse impact of the rule on the housing market, it is not a viable long-term solution, and does little to establish the certainty needed for a strong private secondary mortgage market to develop based on sound underwriting principles and product standards. Rather than rely solely on a short-term fix, the regulators should follow Congressional intent and establish a broadly available QRM that will create incentives for responsible liquidity that will flow to a broad and deep market for creditworthy borrowers.

Finally, it is not clearly evident that risk retention itself will attract investors to securitizations backed by non-QRMs. If investors do not find non-QRM securities attractive, or issuers find that the costs of the risk retention rule render securitization unviable, the large non-QRM market created by the rule will be dominated by portfolio lending. This likely means reduced market liquidity, a shift away from 30-year fixed rate loans, and a move toward more portfolio products like ARMs and hybrid ARMs (e.g., a fixed rate for 5 years that converts to a one year ARM).

If this occurs, the risk retention rule is likely to increase systemic risk rather than relieve it. By creating such a narrow QRM market, the capital required to make loans outside of the QRM (which would be most loans made today) will simply not be available to most community-based lenders. The result will be even further concentration of mortgage lending in a small number of institutions, reducing competition and increasing systemic risk.<sup>11</sup>

## **Conclusion**

The proposed QRM rule is narrowly drawn, producing a requirement that is misaligned with three key pillars of Congressional intent:

- **For consumers**, the QRM was intended to provide creditworthy borrowers access to well-underwritten products at good prices. Although Congress intended for QRMs to be accessible to a broad range of borrowers, the regulators acknowledge that they crafted this rule to make the QRM “a very narrow slice” of the market. Despite specific Congressional rejection of down-payment requirements in the QRM legislative provisions, a fact attested to by the QRM sponsors, the regulators have insisted upon a punitive down payment requirement, even when

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<sup>10</sup> RISMedia, April 8, 2011, “Diverse Groups Respond to Proposed Rule for Qualified Residential Mortgages”

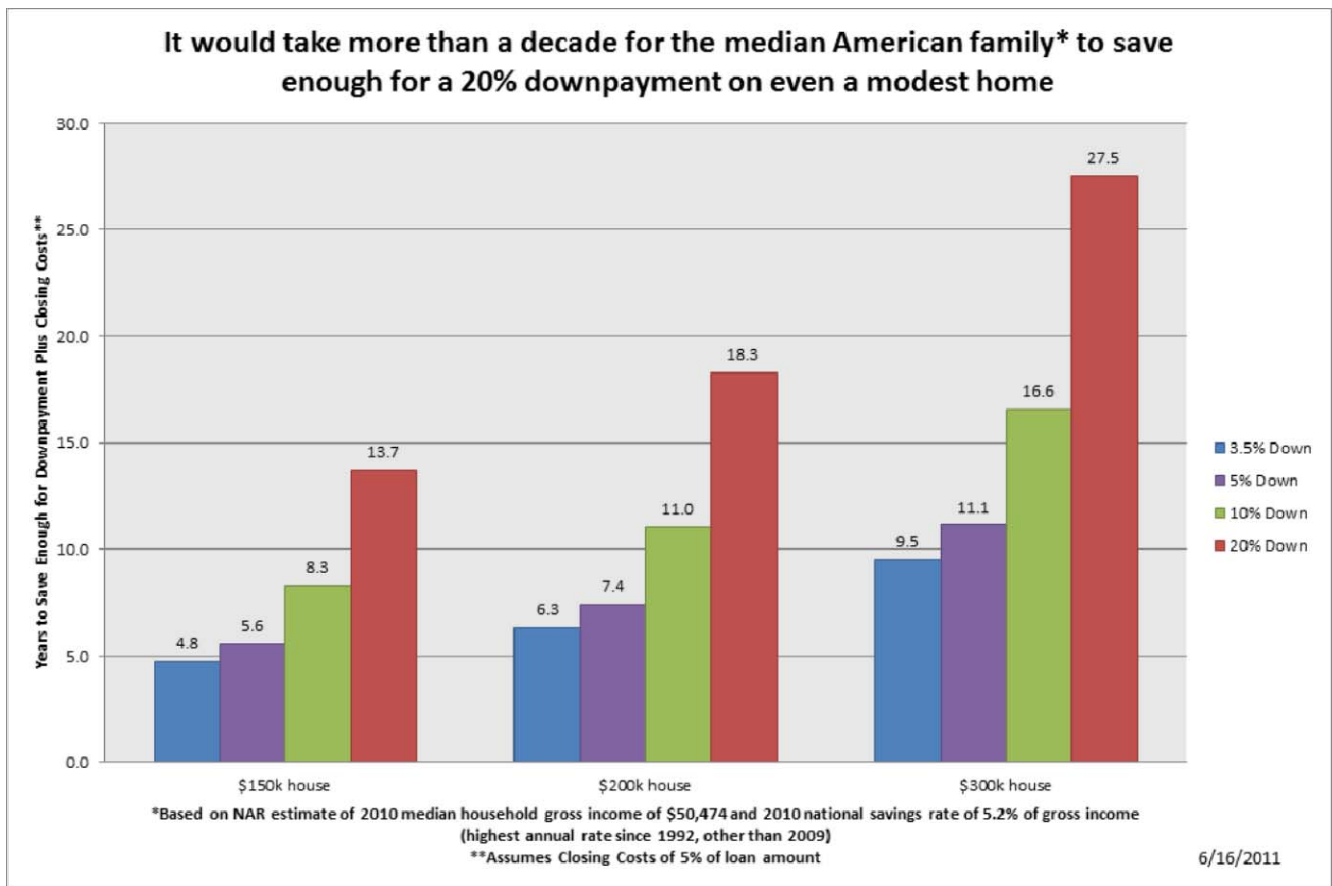
<sup>11</sup> According to National Mortgage News, by the end of 2010, five large banking institutions controlled 60 percent of all single-family mortgage originations.

confronted with ample historical loan performance data that show that low down payment loans perform well provided the loan has been properly underwritten and has consumer-friendly features.

- **For the housing market**, the statutory intent of the QRM was to provide a framework for responsible liquidity provided by private capital that would be broadly available to support a housing recovery. However, the QRM definition in the proposed rule is so narrow that the vast majority of both first-time and existing homeowners will face potentially significantly higher interest rates, or have to postpone purchases and refinances.
- **For the structure of the housing finance market**, the QRM was intended to help shrink the government presence in the market, restore competition and mitigate the potential for further consolidation of the market. Again, the proposed rule is likely to have the opposite impact.

Regulators should redesign a QRM that comports with Congressional intent: **encourage sound lending behaviors that support a housing recovery, attract private capital and reduce future defaults without punishing responsible borrowers and lenders.**

## ATTACHMENT 1

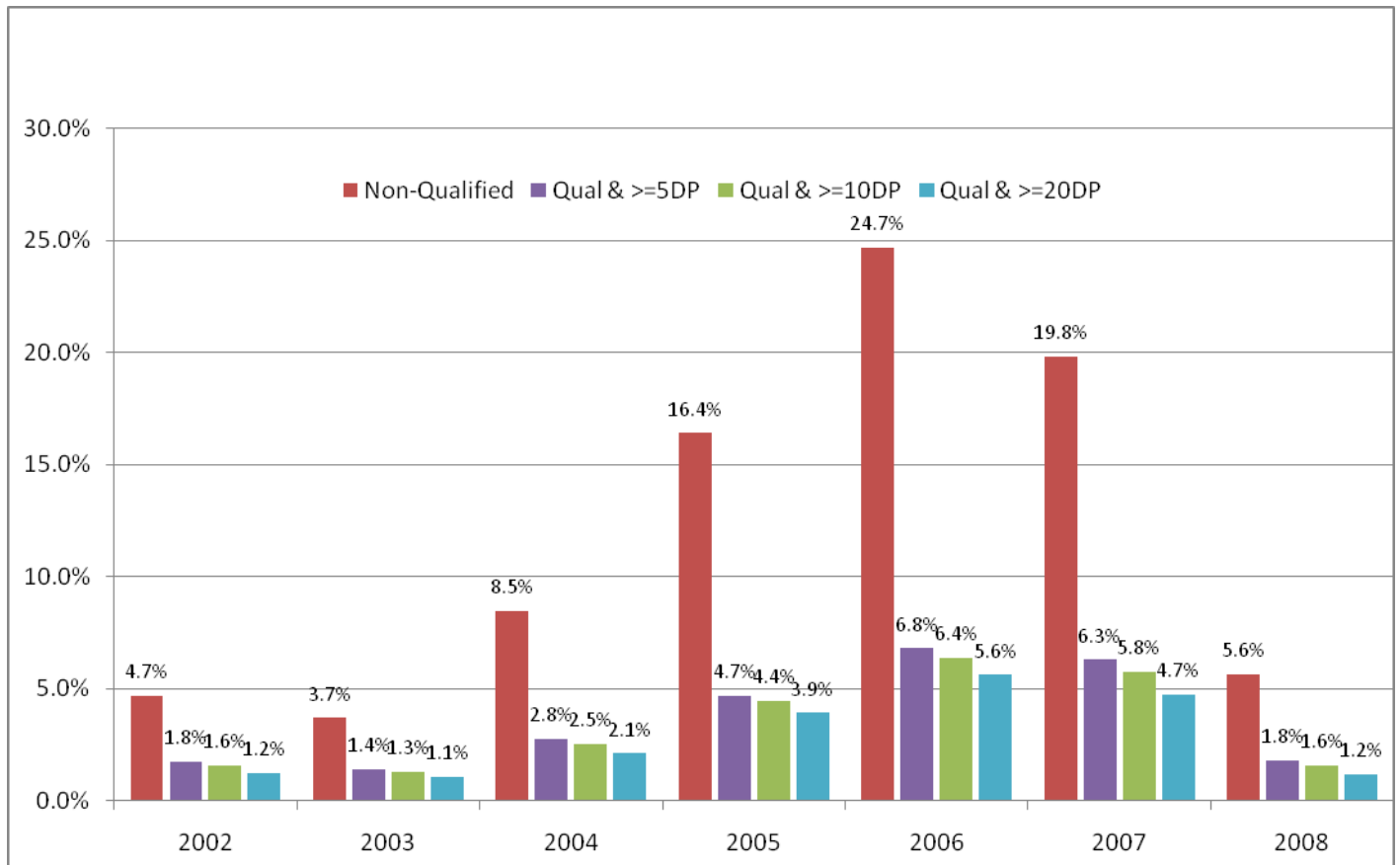


Source: National Association of REALTORS®

## ATTACHMENT 2

# IMPACT OF INCREASING MINIMUM DOWNPAYMENT ON DEFAULT RATES FOR LOANS THAT MEET QRM STANDARDS

**Low Down Payments not a Major Driver of Default when Underwritten Properly**



Source: Vertical Capital Solutions of New York, an independent valuation and advisory firm conducted this analysis using loan performance data maintained by First American CoreLogic, Inc. on over 30 million mortgages originated between 2002 and 2008. The QRM in this analysis is based on fully documented income and assets; fixed-rate or 7-year or greater ARMs; no negative amortization; no interest only loans; no balloon payments; 41% total debt-to-income ratio; mortgage insurance on loans with 80% or greater loan-to-value ratios; and maturities no greater than 30 years.