Proposed QRM Harms Creditworthy Borrowers And Housing Recovery

White Paper Prepared in Advance of April 14, 2011
House Subcommittee on Capital Markets and Government Sponsored Enterprise Hearing

April 13, 2011

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Executive Summary

In the midst of a very fragile housing recovery, the government is throwing a devastating, unnecessary and very expensive wrench into the American dream. First time homebuyers will have to choose between higher rates today or a 9-14 year delay while they save up the necessary down payment. And 25 million current homeowners would be locked out of lower refinancing rates because they lack the required 25 percent equity in their homes.

High down payment and equity requirements will not have a meaningful impact on default rates. But they will require millions of consumers, who are at low risk of default, to either put off buying a home or pay unnecessarily high rates. The government is penalizing responsible consumers, making homeownership more expensive or simply out of reach for millions. We urge regulators to develop a final rule that encourages good lending and borrowing without punishing credit-worthy consumers.

Introduction

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.[1]

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. Additional analysis of these issues will be addressed in updates to this White Paper.

The proposed QRM exemption requires a high down payment – proposed at 20 percent, with even higher levels of minimum equity required for refinancing – despite the fact that Congress *considered and rejected* establishing high minimum down payments because they are not a significant factor in reducing defaults compared to other underwriting and 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.[2]

Requiring down payments of 20 percent or more 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 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 20 percent or more in down payment or equity. **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.**

[1] 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 protections on low down payment loans.

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

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 2009 income and home price data, it would take almost 9 years for the typical American family to save enough money for a 10 percent down payment, and fully 14 years to save for a 20 percent down payment (Table 1). A 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 riskier product features.

Table 1
Years for Median Income Family to Save for Down Payment

	20% Down Payment	10% Down Payment	5% Down Payment
Median Sales Price	$172,100	$172,100	$172,100
Down payment + Closing Costs (est. @ 5%)	$43,025	$25,815	$17,210
# of Years Needed to Save @ $3000 per year	14 years	9 years	6 years

Source: Center for Responsible Lending Issue Brief, "Don't Mandate Large Down Payments on Home Loans." Based on NAR's 2009 median home price of $172,100, and median family income of $49,777. At $3000 per year, the savings rate in the example is 6%, equal to the current savings rate, which is at the highest annual level since the early 1990s.

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 purchased their homes with 20 percent or more down and paid their mortgages on time for years, only to see their equity eroded by a housing crash caused by others and the severe recession. Even with a 10 percent minimum equity standard, more than 16 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.

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

47.9 million U.S. homeowners with mortgages:	**30% equity**	**25% equity**	**20% equity**	**10% equity**
# with less than…	27.5 million	24.8 million	21.9 million	16.3 million
% with less than…	57%	52%	46%	34%

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

As now narrowly drawn, QRM 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.[3] 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.** As shown in Table 3 (and in Attachment 2), moving from a 5 percent to a 10 percent down payment *on loans that already meet strong underwriting and product standards*[4] reduces the default experience by an average of only two- or three-tenths of one percent. 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.

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

Year	2002	2003	2004	2005	2006	2007	2008
Reduction in default rate* by increasing down payment **from 5% to 10%**	0.2%	0.1%	0.3%	0.3%	0.2%	0.5%	0.2%
Proportion of borrowers **not eligible** 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 down payment **from 5% to 20%**	0.6%	0.3%	0.7%	0.8%	0.8%	1.6%	0.6%
Proportion of borrowers **not eligible** 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.

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% minimum down payment on that cohort, to a 10 percent and a 20 percent minimum down payment. 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, rather than simply 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

[3] 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.

[4] 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.

major adverse impact on access by creditworthy borrowers to the lower rates and safe product features of the QRM.

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 a rule that imposes 5 percent risk retention across such a broad segment of the market.

Some private estimates have concluded that 5 percent risk retention could result in a three-percentage point rise in interest rates for loans funded through securitization.[5] In other words, today's 5 percent market would become an 8 percent interest-rate market. While that estimate may be high, even 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 5 percent to 6 percent) means that 4 million households would no longer be able to qualify for the median-priced home. A 3-percentage point increase would price out over 12 million households. 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.

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.

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 **30% equity**	…less than **25% equity**	… less than **20% equity**
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.

All of these borrowers have already put significant "skin in the game" through down payments and years of timely mortgage payments, but the proposed QRM definition tells them they are not "gold standard"

[5] Report by JP Morgan Securities Inc., Securitization Outlook, December 11, 2009.

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.**

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 noted by economist Mark Zandi in a detailed 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."[6]

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 and without regulations that mandate sound underwriting standards. It is not clear whether investors view risk retention as a sufficient substitute for good underwriting, strong documentation, and well-structured mortgage products.

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."[7]

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, risk retention is a viable option only for the largest banking institutions that have balance sheets to handle it. In 2000, the top 5 lenders accounted for less than 29 percent of total mortgage originations. Today, just three FDIC-insured banks control nearly 55 percent of all single-family mortgages originations. By creating such a narrow QRM market, the proposed rule will reduce

[6] Moody's Analytics Special Report, "The Skinny on Skin in the Game," March 8, 2011, by Mark Zandi (page 3).
[7] RISMedia, April 8, 2011, "Diverse Groups Respond to Proposed Rule for Qualified Residential Mortgages"

competition from community-based lenders and accelerate consolidation of the mortgage finance market. In short, the proposal creates real systemic risk, while doing little to relieve it.

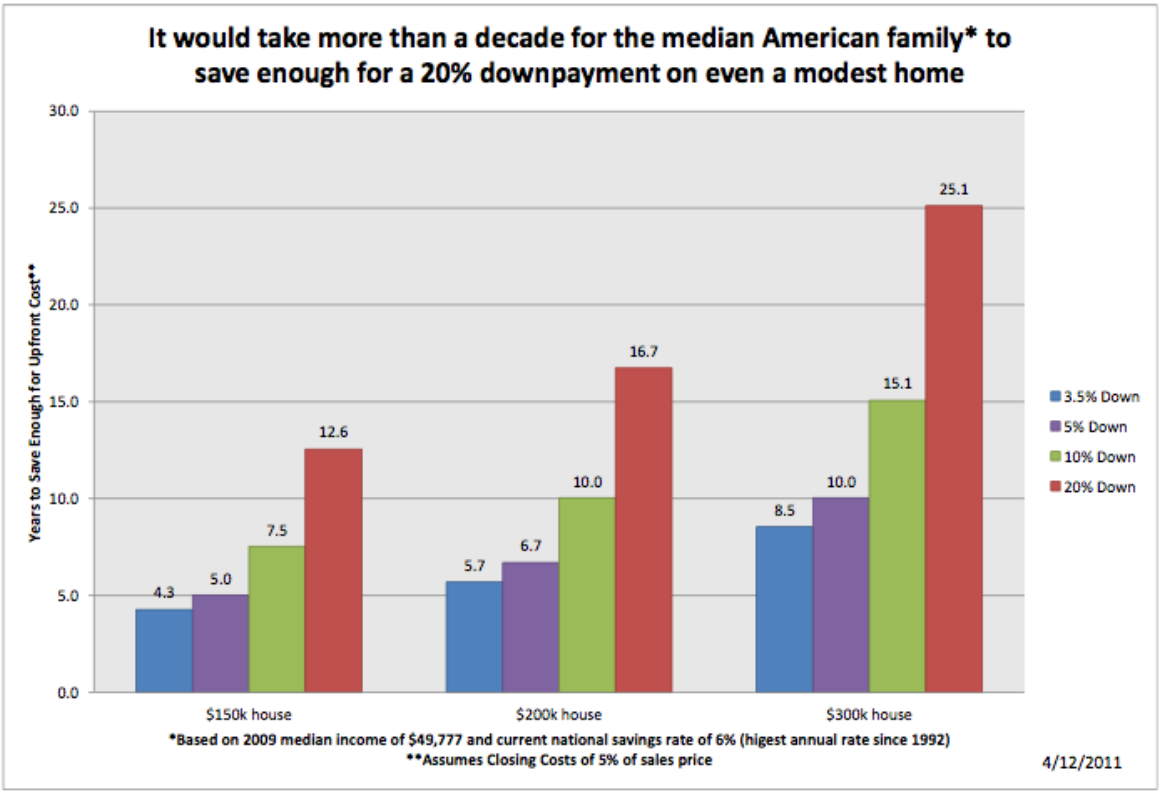
Conclusion

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. Although Congress intended for QRMs to be broadly available, the regulators acknowledge that they crafted this rule to make the QRM "a very narrow slice" of the market.
- 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 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

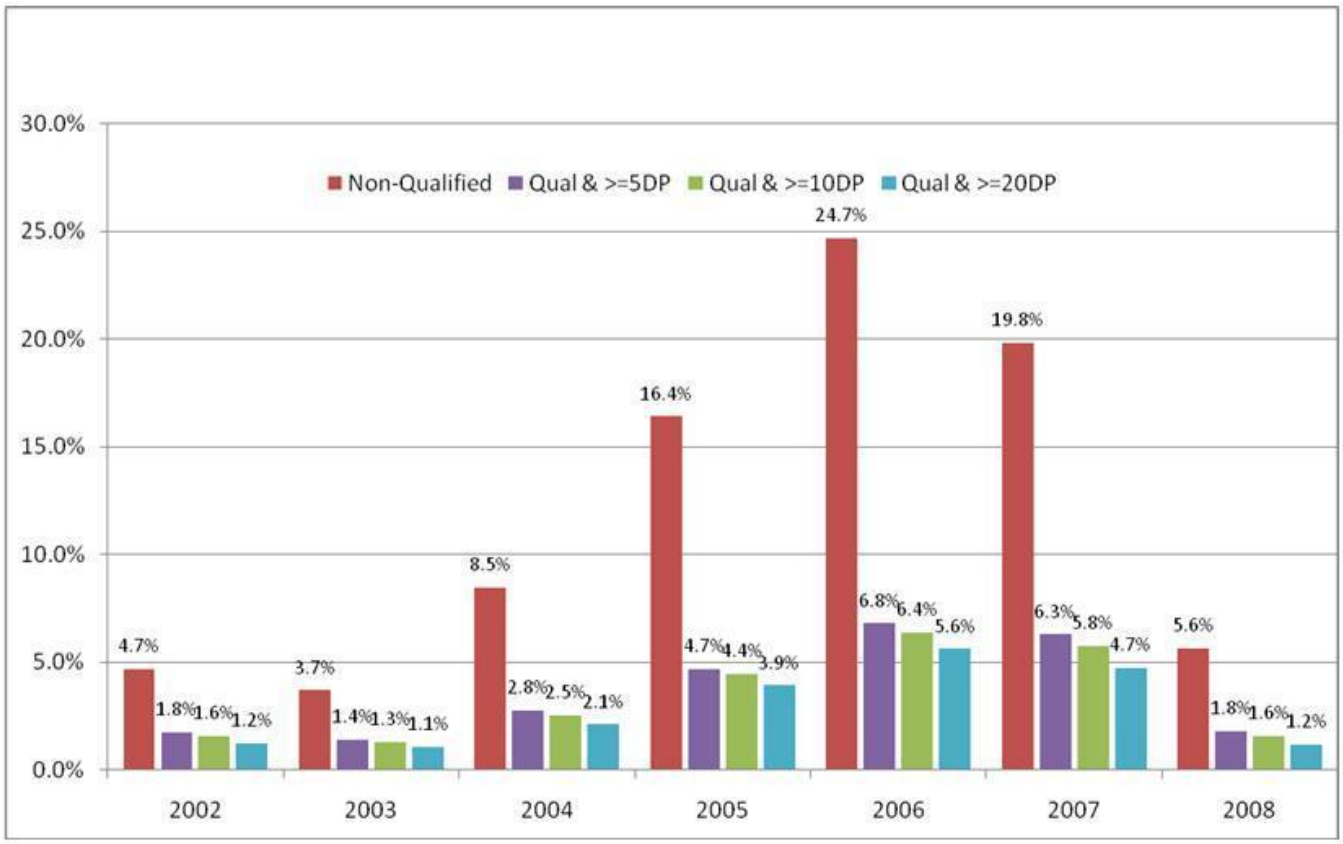


Source: National Association of Realtors®

ATTACHMENT 2

IMPACT OF INCREASING MINUMUM 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.