Regulators Should Adopt the Qualified Mortgage Standard for the Qualified Residential Mortgage Definition

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Overview

In finalizing regulations to define a Qualified Residential Mortgage (QRM), regulators should adopt the same standards that the Consumer Financial Protection Bureau (CFPB) used in defining a Qualified Mortgage (QM). QRM should be the same as QM for three reasons:

- **QM definition appropriately implements the risk retention requirement:** Because the QM standard excludes mortgages with risky features that have a higher propensity to default and requires affordability by the borrower, using the QM standard to determine when a loan requires risk retention would appropriately implement the statute.

- **Benefits of adding a down payment requirement are low.** Layering on a down payment restriction on top of the QM definition – in addition to the borrower funds needed to pay for closing costs and escrows, which generally total around 3 percent of the loan balance – would provide limited incremental benefits in reducing default rates.

- **Costs of adding a down payment requirement are high.** Adding a down payment requirement as part of the QRM definition would needlessly deny access to mainstream credit for lower-income households and borrowers of color who have the ability to repay their mortgages. In addition, making the QRM and QM standards different would create additional, needless complexity for lenders, particularly smaller ones.

By applying the same definition for QM and QRM loans, regulators will ensure that there is access to credit for low-risk privately-securitized loans. Furthermore, adopting this policy will also ensure that there is skin-in-the-game and risk retention for non-QM mortgages – which have riskier features – that are packaged into private-label securities.

1. Using the QM Standard to Define QRM Appropriately Implements Risk Retention.

Because the QM standard excludes mortgages with risky features that have a higher propensity to default and requires affordability by the borrower, using the QM standard to determine when a loan requires risk retention would appropriately implement the statute. The QM rulemaking addresses the core causes of the subprime lending crisis, which was fueled by mortgages with risky product features (i.e., 2/28s, interest-only mortgages) and by lenders that failed to assess a borrower's ability to repay a mortgage.[1] Under the CFPB's final rule issued on January 10, 2013,

[1] *See e.g.*, Debbie Gruenstein Bocian, Wei Li, Roberto G. Quercia, *Lost Ground, 2011: Disparities in Mortgage Lending and Foreclosures*, Center for Responsible Lending (November 2011).

loans must be fully documented by the lender. QM loans are limited to thirty years, must be fully amortizing and limited to three points in upfront fees. Adjustable-rate mortgages will be eligible for QM status only if they are underwritten at the maximum possible rate for five years. Prepayment penalties and balloon loans are significantly restricted, and many higher-cost mortgages will be required to have escrow accounts for taxes and insurance payments. In addition, loans eligible for sale to the GSEs or insurable by FHA[2] will also gain QM status for a temporary seven-year period, and other loans cannot exceed a debt-to-income ratio of 43 percent.

As a result of excluding loans with risky features and requiring that borrowers be able to repay a mortgage, the QM definition on its own excludes loans with a higher risk of default. Data demonstrates that restricting risky product features alone has a significant impact on reducing default rates. A report, *Balancing Risk and Access,* completed by the Center for Community Capital at the University of North Carolina at Chapel Hill and CRL analyzes nearly 20 million mortgages made between 2000 and 2008. The study found the following default rates through February 2011:[3]

- 5.8% for mortgages meeting QM product requirements[4]
- 7.7% for prime conventional loans
- 11.0% for the entire study sample
- 22.3% for Alt A mortgages
- 32.3% for subprime mortgages.

This reduced default rate for loans meeting QM standards is significant, especially when considering that the study includes performance data through the foreclosure crisis. Additionally, the reduced default rate of 5.8 percent for mortgages meeting QM product features does not factor in the CFPB's 43 percent back-end DTI cut-off for non-GSE and non-FHA mortgages or imposition of the strict GSE underwriting standards.

2. Layering on a Down Payment Restriction Would Provide Limited Incremental Benefits in Reducing Default Rates.

A down payment requirement should not be layered on top of the QM standard for purposes of defining QRM and determining which mortgages require risk retention. First, adding a down

[2] FHA has indicated its intent to issue a Qualified Mortgage rulemaking for mortgages insured by FHA, which would result in sunsetting the portion of the CFPB's regulation stating that a loan can be QM if it meets the product feature requirements in addition to being eligible for FHA insurance.

[3] Roberto G. Quercia, Lei Ding, Carolina Reid, *Balancing Risk and Access: Underwriting Standards for Qualified Residential Mortgages*ˆ, Center for Community Capital and Center for Responsible Lending (Revised March 5, 2012).

[4] *Id*. at 13 (stating that the study defines QM product features "as those that 1) have full documentation, 2) are not interest-only or negative amortization loans, 3) do not include a balloon payment, 4) do not have adjustable interest rates with fixed terms under five years, 5) do not have a maturity of greater than 30 years, and 6) do not include a prepayment penalty.").

payment requirement on top of the QM product requirements produces a limited benefit in terms of reducing default rates. *Balancing Risk and Access* found that requiring a 10 percent down payment reduces the default rate for loans meeting the QM product restrictions from 5.8 percent to 4.7 percent. This is a marginal benefit. Second, this comparison between 5.8 percent and 4.7 percent does not factor in an important part of the CFPB's definition for QM loans, which is that QM loans either meet a DTI cut-off or adhere to agency underwriting standards. A separate part of the *Balancing Risk and Access* study suggests that layering a DTI cut-off on top of the QM product requirements will further reduce default rates.[5] As a result, the relative benefits of adding a down payment requirement would likely be further limited given that QM loans will also meet these affordability requirements.

3. The Costs of Adding Restrictive Down Payment Standards Would Be High, Particularly in Denying Access to Credit for Lower-Income Households and Borrowers of Color Who Have the Ability to Repay Their Mortgages.

In defining what kind of mortgages qualify for QRM status, regulators have a responsibility to appropriately weigh the benefits and costs of including additional restrictions and pushing more mortgages into a non-QRM category. The significant costs of down payment requirements for lower-income households and borrowers of color outweigh any limited benefit, as described above, that they would provide for investors and the financial system as a whole. As a result, regulators should exclude down payment requirements from the QRM definition.

A. Lower Down Payment Mortgages Are Not Uniquely High Risk.

Regulators must avoid conflating lower down payment mortgages with those that have risky features. Low down payment loans, when paired with responsible underwriting and safe loan terms, have proven to be a successful strategy for expanding sustainable homeownership for decades. For example, for the last 14 years, CRL's affiliate Self-Help has operated a national secondary market home loan program that has purchased 52,000 mortgages worth $4.7 billion.[6] Borrowers in 72% of these mortgages made less than a 5 percent down payment. In addition, 41 percent were female-headed households, 40 percent were from minority households and median income was $30,792. These loans have performed well: they have a median annualized net return on borrower equity of 24 percent and Self-Help's cumulative loss rate has been 3 percent. The loans were originated by 35 lenders in 48 states, and virtually all would meet the qualified mortgage/qualified residential mortgage product requirements legislated in Dodd-Frank.

As demonstrated by Self-Help's experience, how much borrowers need to invest in order to feel adequately committed varies by their financial condition. For example, a three percent down payment for a lower-income family may be just as effective a personal investment as 20 percent

[5] *Id*., at 19.
[6] See generally Quercia, Freeman and Ratcliffe, *Regaining the Dream: How to Renew the Promise of Homeownership for America's Working Families*, UNC Center for Community Capital (2011) (discussing program).

for a wealthier family. Additionally, it should be noted that Congress affirmatively considered but did not include down payment requirements as one of the factors that regulators should consider when examining default rates in order to establish the QRM definition.[7]

B. Down Payment Requirements in the QRM Definition Would Restrict Access to Credit for Otherwise Qualified Borrowers.

In addition to misdiagnosing the cause of the subprime lending crisis, a QRM definition that layers on down payment standards would further restrict access to credit, particularly for lower-income borrowers and borrowers of color.[8] Communities of color have lost considerable wealth as a result of the subprime lending boom and the resulting foreclosure crisis.[9] Lending decisions should not be precluded – or made more expensive – as a result of the QRM rule that adds an incremental amount of safety to privately securitized loans at the expense of widespread denial of access to groups disproportionately harmed by the foreclosure crisis.

One way to measure the access to credit costs of a down payment requirement is how long households would need to save in order to meet the down payment threshold. Increasing this time period could either delay (or entirely eliminate) a borrower's ability to access a mainstream mortgage product or increase their lending costs by pushing them into a more expensive non-mainstream product, likely with fewer borrower protections. Given 2011 median housing prices and incomes, it would take *22 years* for the typical family to save a 10 percent down payment plus closing costs, as well as *14 years* to save for a 5 percent down payment. The increased barriers would be even greater for typical African-American and Latino families, for whom it would take *34 and 28 years*, respectively, to save enough to meet a 10 percent requirement and *21 and 17 years*, respectively, for a 5 percent requirement.[10] If the down payment requirement were instead 30 percent, it would take the typical family 56 years to save for the down payment and closing costs, and the typical African-American and Latino family *85 and 72 years*, respectively, assuming they could live and work that long.

Imposing a down payment requirement will unnecessarily exclude a large percentage of African-American and Latino borrowers from accessing mainstream mortgage products. The *Balancing*

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[7] Public Law 111-203, Section 941(b).

[8] Similar access to credit concerns would exist if regulators added other unnecessary underwriting criteria – such as a more restrictive debt-to-income requirement beyond what QM imposes or an inherently inaccurate proxy of a credit score of a certain number defined by credit delinquencies – to the QRM definition.

[9] *See e.g.*, Debbie Gruenstein Bocian, Peter Smith and Wei Li, *Collateral Damage: The Spillover Costs of Foreclosures*, Center for Responsible Lending (October 24, 2012).

[10] Based on purchase of a 2011 median priced house ($173,600) by borrower with median income in 201110 ($50,502). We assume an annual savings rate dedicated for down payment of 2%. Median income for 2011 is from American Community Survey. Our savings rate assumption is derived from the Bureau of Economic Analysis's average savings rate for 2012 of 3.9 percent. However, since BEA's rate is based on take home, not gross, income, it translates to a 2.8 percent rate for gross income, assuming a combined federal, state and local tax rate of 28.3 percent (see effective tax burden for the middle quintile of households at http://taxfoundation.org/sites/taxfoundation.org/files/docs/wp1.pdf, page 14). We then assume that, of this 2.8 percent, 2 percentage points can be dedicated toward a down payment, leaving families with the remainder of savings (0.8 percentage points) for retirement, college and emergencies.

Risk and Access study looked at borrowers who were *successfully* paying on their mortgage as of February 2011 to determine how many of these borrowers would have been excluded from obtaining a mainstream mortgage if down payment requirements had been in place at the time they took out their loans. A 10 percent down payment requirement would have excluded 60 percent of African-American borrowers and 50 percent of Latino borrowers who were current as of February 2011. A five percent down payment requirement would have locked out 33 percent of successful African-American and 22 percent of successful Latino borrowers at that time. A 30 percent down payment requirement would have excluded 94 percent of African-American and 91 percent of Latino borrowers who were successfully paying their mortgages.

In addition to the added costs or lack of access to loans that do not receive QRM status, a down payment requirement in QRM could lead Congress to include it in future FHA and GSE reforms, magnifying the damage. With households of color accounting for an estimated seven out of ten net new households between 2010 and 2020, a government-mandated down payment requirement could exclude a large portion of the market from accessing affordable mortgages.[11] Such a result would likely depress home prices, decreasing the home equity of families across the country, and act as a drag on economic growth and employment. In doing so, it could increase overall defaults, undermining its primary objective of reducing individual default rates.

Making the QRM and QM standards different would create additional, needless complexity for lenders, particularly smaller ones, in complying with overlapping but different QM and QRM standards at a time when lenders must adopt numerous other mortgage-related rules. In addition, given that QM includes GSE loans, layering on additional requirements only for privately securitized loans would put private capital at a disadvantage and make it more difficult to restart the private securitization market.

Finally, aligning QM and QRM would give regulators the time to evaluate the impact of the QM standards, both to confirm the likely impact that default rates will be extremely low and to assess its impact on the housing market.

[11] See *The State of Housing 2012*, Joint Center for Housing Studies at Harvard University, http://www.jchs.harvard.edu/research/publications/state-nation%E2%80%99s-housing-2012 at 13.