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IN FOCUS

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QRM: Risk Retention and the Mortgage Market

In October 2014, federal regulators issued a final rule implementing the credit risk retention (CRR) requirement of Section 941 of the Dodd-Frank Act (DFA). The CRR rule applies to many different types of asset-backed securities (ABS), including ABS backed by student loans, auto loans, credit card receivables, and other asset classes. This *In Focus*, however, focuses on the elements of the rule related to the residential mortgage market.

Risk Retention

What Is Securitization? *Securitization* is the process in which an institution acquires and pools assets that have a stream of payments and issues securities to investors. The streams of payments of the assets are forwarded to the investors who purchase the securities. The assets that are the source of the underlying payments are said to *collateralize* the security, thus making it an asset-backed security. In the case of a mortgage-backed security (MBS), the assets that are pooled together are mortgages. The institution that organizes and initiates the securitization transaction is the *sponsor* of the securitization. The sponsor could be a bank or a nonbank, and the CRR rule applies to both.

What Is Credit Risk? *Credit risk* is the risk that a borrower will not repay its debt as required. In the case of a MBS, if homeowners do not make their monthly mortgage payments, less money would be paid to investors who purchased the MBS that is collateralized by those mortgages.

What Is the Credit Risk Retention Rule? Under the CRR rule, the sponsor of a securitization is required to retain at least 5% of the credit risk of the assets that comprise the ABS. The sponsor, with a few exceptions, is not allowed to hedge or transfer the credit risk that it is required to retain. The requirement to retain risk expires after several years, depending on the type of assets collateralizing the ABS. In some cases, if the assets that collateralize the ABS meet certain requirements indicating a low credit risk, the sponsor may be allowed to retain less than 5% of the credit risk. In the case of mortgages, if all the mortgages collateralizing a MBS are *qualified residential mortgages* (QRMs), then the sponsor does not have to retain any of the credit risk. Securitizing QRMs is a way for a sponsor to be exempt from the risk retention requirements.

Why Was This Rule Adopted? In its deliberations on the DFA, Congress noted that the financial crisis shed light on several weaknesses in securitization transactions and attempted to address those weaknesses in various portions of the act. One of the weaknesses addressed by the CRR rule concerned the *originate-to-distribute* (OTD) model of funding mortgages. The OTD model describes a process in which mortgages were originated with the intention of securitizing them and selling the MBS to investors. Because those involved in the securitization process sold the credit risk to other investors, the argument goes, the securitizer did not have sufficient incentive to ensure that the underlying mortgages in the MBS were made to borrowers who would repay. Some argue that this led to a loosening of underwriting standards for mortgages. By requiring a securitizer to retain some of the credit risk (have some "skin in the game"), the securitizer may have more incentive to monitor the quality of the underlying assets. Others, however, question the extent to which the OTD model contributed to the financial crisis, arguing that securitizers often retained risk in their deals for their own business purposes.

> "Congress intended the risk retention requirements… to help address problems in the securitization markets by requiring that securitizers, as a general matter, retain an economic interest in the credit risk of the assets they securitize." — Preamble to the CRR Rule

Qualified Residential Mortgage

What Is a QRM? Section 941 of the DFA provided the regulators with some discretion in coming up with a definition for QRM. It directed the regulators to take "into consideration underwriting and product features that historical loan performance data indicate result in a lower risk of default." Section 941 also directed the regulators to make the QRM definition "no broader" than the definition for a *qualified mortgage* (QM). In the CRR Rule, the regulators decided to align the definition for QRM with the definition of QM, meaning that a mortgage is a QRM if it meets the definition for QM. The definition of QRM is significant because, as mentioned before, if all the assets in a MBS are QRM, the sponsor of the securitization is exempt from retaining the credit risk.

What Is a QM? Title XIV of the DFA established the ability-to-repay (ATR) requirement and instructed the Consumer Financial Protection Bureau (CFPB) to establish the definition for QM as part of its implementation. The ATR rule requires a lender to determine based on documented and verified information that at the time a mortgage loan is made, the borrower has the ability to repay the loan. Lenders that fail to comply with the ATR rule could be subject to legal liability.

A lender is presumed to have complied with the ATR rule when it offers a QM. A QM is a mortgage that satisfies certain underwriting and product feature requirements, such as being below specified debt-to-income ratios, having a term of 30 years or fewer, and having fees associated with the mortgage below certain thresholds. There are several different categories of a QM, including mortgages made by small lenders and lenders in rural or underserved areas and mortgages that meet the standards of Fannie Mae and Freddie Mac.

In sum, offering a QM is one way for a lender to comply with the ATR rule while securitizing a QRM is a way for a sponsor to be exempt from the risk retention requirements. The ATR rule addresses underwriting requirements in the primary mortgage market (i.e., the market where a mortgage is made), and the CRR rule concerns securitization requirements in the secondary mortgage market (i.e., the market where mortgages are bought and sold).

Does QRM Have a Downpayment Requirement? Although the proposed CRR rule generally would have required a mortgage to have a 20% downpayment to qualify as a QRM, the final CRR rule does not require a minimum downpayment.

Why Align QRM and QM? In the preamble to the final rule, the regulators state that aligning QM and QRM "meets the statutory goals and directive of [the risk retention requirement] to protect investors and enhance financial stability, in part by limiting credit risk, while also preserving access to affordable credit and facilitating compliance." Aligning the two definitions could also reduce the regulatory compliance burden associated with having two different mortgage standards.

Although many consumer and industry groups support the alignment of QM and QRM, others, such as former Representative Barney Frank, argue that QRM should have a stricter definition and only the highest quality mortgages should be exempted from the CRR rule.

Besides QRM, Are There Other Mortgage-Related Exemptions or Options to Risk Retention? The CRR rule includes several other mortgage-related exemptions and options. For example, Fannie Mae and Freddie Mac do not need to retain additional credit risk beyond the guarantee that they provide on their MBS so long as they continue to operate under conservatorship or receivership of the Federal Housing Finance Agency (FHFA) and are receiving support from the U.S. Treasury.

All ABS fully guaranteed by the government are exempt from the CRR rule. MBS guaranteed by Ginnie Mae, therefore, are exempt because Ginnie Mae is a government agency that guarantees MBS composed of government-insured mortgages.

Certain community focused residential mortgages, such as those originated by eligible non-profit organizations, are not QMs (and because they are not QMs, they are not QRMs) but are exempt from the ATR rule. The CRR rule also provides an exemption from risk retention for certain community-focused residential mortgages.

The Rulemaking Process

Who Issued the Rule? The portions of the final rule dealing with residential mortgages were jointly issued by the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation (FDIC), the Securities and Exchange Commission (SEC), the FHFA, and the Department of Housing and Urban Development (HUD). FHFA and HUD were not part of the portions of the rule that addressed non-mortgage assets.

When Does the Credit Risk Requirement Go Into Effect? The rule (not yet published) is effective one year after it is published in the *Federal Register* for MBS and two years after it is published for other types of ABS.

Will the QRM Definition Be Reviewed? The regulators will review the definition of QRM at least every five years to ensure it is consistent with the DFA's requirements.

Selected Policy Issues

Does the Definition of QRM Balance the Goals of Credit Availability and Incentive Alignment? Some argue that regulators should define QRM as broadly as possible under the statutory framework to free up mortgage credit. Others argue that requiring risk retention is important to aligning the incentives of securitizers and investors. Exempting a large part of the market through a broad definition of QRM, they argue, undermines the efficacy of the CRR rule.

How is the CRR Rule Addressed in the Housing Finance Reform Proposals? H.R. 2767, the PATH Act, would repeal the CRR requirement. S. 1217, the Housing Finance Reform and Taxpayer Protection Act, would provide a government guarantee for some MBS, which would make those MBS exempt from the CRR requirement.

Will Finalizing the CRR Rule Jumpstart the Private-Label Securities (PLS) Market? In the aftermath of the financial crisis, the PLS market—the market for MBS that do not have a government guarantee—has shrunk dramatically. Some analysts argue that the absence of the CRR rule created uncertainty for the PLS market and contributed to its reduction. While finalizing the CRR rule will reduce some of that uncertainty, other issues remain that may contribute to the PLS market's current state, including uncertainty about the future of housing finance reform, unresolved legal cases stemming from the financial crisis, and other structural issues related to PLS.

In addition, some argue that Fannie Mae's and Freddie Mac's exemption from having to retain additional risk under the CRR rule further entrenches their large role in the market at the expense of PLS. Others counter that their guarantee already exposes them to a significant amount of credit risk independent of the CRR rule.

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