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# Ability to Repay, Risk-Retention Standards, and Mortgage Credit Access


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# Summary

Prior to the recent financial crisis, mortgage underwriting standards were relaxed to the point where many borrowers could only repay their loans if favorable financial conditions that existed at the time of origination remained intact. In other words, borrowers obtained mortgage loans that relied upon interest rates not rising or the value of the underlying collateral (house prices) not declining. When market conditions changed, however, many mortgage loans became delinquent and went into default. The mortgage defaults often translated into large losses for both the borrowers and the financial industry.

After enactment of The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act; P.L. 111-203), the Federal Reserve Board announced a proposed qualified mortgage (QM) rule that would establish "ability to repay" standards for mortgage lending. The Federal Reserve, along with other federal regulatory agencies, also jointly released a proposed risk retention or qualified residential mortgage (QRM) rule to require parties involved in a transaction in which mortgage originations are sold to retain "skin-in-the-game" or a minimum percentage of the credit risk of financial products, which would result in the sharing of any eventual losses. Adoption of ability to repay and risk-retention standards may discourage lenders from excessively relaxing lending standards even during economic boom periods, thus making loan repayment more resilient to sudden shifts in short-term economic and financial conditions.

The ability to repay and risk-retention standards, while designed to curtail the pre-crisis proliferation of risky lending practices, are likely to simultaneously reduce access to mortgage credit. Although ability-to-repay standards would encourage consistent underwriting at all times, some borrowers that benefit from lender flexibility during more favorable macroeconomic conditions are likely to face increased difficulty obtaining mortgage loans. Lenders may be reluctant to originate loans that are not in compliance with the ability-to-repay standards if this exposes them to increased legal risks. Likewise, risk-retention standards that translate into more stringent qualification requirements for borrowers are likely to increase barriers to homeownership for both creditworthy and disadvantaged borrowers.

The 112$^{th}$ Congress is overseeing the rulemaking stemming from the Dodd-Frank Act. This report examines the developments associated with the implementation of mortgage lending reforms. After summarizing the proposed ability to repay and risk-retention standards, a description of risky underwriting practices that occurred prior to the mortgage crisis is presented, followed by a discussion of possible effects on mortgage credit accessibility.

The Consumer Financial Protection Bureau (CFPB), which will prescribe final regulations on QM rule, has re-opened the comment period to seek further comments on the litigation risks that could potentially arise from the new requirements. The comments, however, should be narrowly focused and based upon analysis that uses mortgage data provided by the regulator of Fannie Mae and Freddie Mac. The closing date for comments will be July 9, 2012.

# Contents



## Tables



## Contacts

# Introduction

Prior to the recent financial crisis, mortgage underwriting standards were relaxed to the point where many borrowers could only repay their loans if the favorable financial conditions that existed at the time of origination remained intact. In other words, borrowers were able to obtain mortgage loans that relied upon interest rates not rising or the value of the underlying collateral (house prices) not declining. When market conditions changed, however, many mortgage loans became delinquent and went into default. The mortgage defaults often translated into large losses for both the borrowers and the financial industry.

"Irrational exuberance," a term coined by then-Federal Reserve Chairman Alan Greenspan, arguably captures the essence of the academic work of Hyman Minsky[1] and has been used to illustrate the dynamics that contributed to the recent financial crisis. According to Minsky, when lenders grow excessively optimistic, they increase credit availability as if the ideal economic and financial market conditions will persist. Lender optimism during the height of a business cycle can translate into a substantial increase in debt accumulation or "leveraging" by the private sector. Moreover, leveraging in response to a particular asset market bubble can result in overinvestment into a particular sector (such as housing) as well as numerous financial portfolios lacking diversification outside of one broad asset class. A "Minsky moment" subsequently occurs when assets are unable to continue generating the level of revenues necessary to repay the loans that were used to purchase them. In other words, the expected future value of the collateral used to secure the loan fails to increase and may even decline, and the borrower lacks the income stream or the ability to sell the asset to repay the outstanding loan balance. Recessions that occur after individuals have accumulated large levels of debt, therefore, are likely to be more severe than those characterized by lower debt levels. An escalation of defaults is likely to occur after a proliferation of leveraged investments have gone sour, which debilitates the banking system and impedes any subsequent lending necessary to stimulate recovery.

Rulemaking is now taking place to implement "ability to repay" and risk-retention standards as mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act; P.L. 111-203). Under the Dodd-Frank Act, mortgage originators are required to make a good faith determination that a borrower has a reasonable ability to repay the loan regardless of the prevailing financial conditions. In addition, parties involved in a securitization[2] transaction must retain "skin-in-the-game" or a minimum percentage of the credit risk, which would further encourage greater due diligence given the sharing of any eventual losses. Hence, the ability to repay and risk-retention measures address some risky financial practices that arguably contributed to recent excessive mortgage debt accumulation and subsequent financial crisis.

The ability to repay and risk-retention standards would dampen any future periods of rapid mortgage debt accumulation by encouraging lenders to adopt qualification standards higher than

[1] See Hyman P. Minsky, *The Financial Instability Hypothesis*, The Jerome Levy Economics Institute, Working Paper No. 74, May 1992, and Justin Lahaar, "In Time of Tumult, Obscure Economist Gains Currency: Mr. Minsky Long Argued Markets Were Crisis Prone; His 'Moment' Has Arrived," *Wall Street Journal*, August 18, 2007, at http://online.wsj.com/article/SB118736585456901047.html.

[2] A mortgage securitization transaction involves selling mortgages to a securitizer who pools them and creates a mortgage-backed security. The subsequent payment streams are then sold to various groups of investors. For more information, see CRS Report RS22722, *Securitization and Federal Regulation of Mortgages for Safety and Soundness*, by Edward V. Murphy.

those that existed prior to the financial crisis. Although some borrowers may qualify for loans when underwriting criteria are relaxed, which typically may occur at times when housing and macroeconomic conditions are more favorable for repayment, lenders may be reluctant to originate those that fail to comply with qualification standards that would reduce their exposures to legal risks. Hence, some creditworthy borrowers may be unable to obtain mortgage credit.

The 112$^{th}$ Congress is monitoring the rulemaking stemming from the Dodd-Frank Act. This report examines the developments associated with the implementation of mortgage lending reforms. The report begins with a summary of proposed ability to repay and risk-retention standards. Next, the report describes risky underwriting and financing practices that occurred prior to the mortgage crisis, followed by a discussion of how access to mortgage credit might be affected.

# Overview of Regulatory Actions

This section provides an overview of the proposed rules having to do with the ability to repay and risk-retention standards. Regulatory reforms will require creditors to consider whether borrowers have the ability to repay loans, and loan originators will also have to adhere to stricter underwriting or borrower qualification standards if they choose to sell loans to securitizers. Ability to repay and risk-retention standards are designed to provide lenders and securitizers with legal protection when they refrain from lending practices that weaken overall financial stability as well as to protect borrowers from assuming mortgage obligations that are affordable only under certain circumstances.

## Ability to Repay Standards and Qualified Mortgages

Title XIV of the Dodd-Frank Act is entitled the Mortgage Reform and Anti-Predatory Lending Act; Section 1411 is entitled "Ability to Repay" and says,

> In accordance with regulations prescribed by the (Federal Reserve) Board, no creditor may make a residential mortgage loan unless the creditor makes a reasonable and good faith determination based on verified and documented information that, at the time the loan is consummated, the consumer has a reasonable ability to repay the loan, according to its terms, and all applicable taxes, insurance (including mortgage guarantee insurance), and assessments.

Minimum standards for residential mortgage loan originations, which consist of factors that creditors are required to consider during the underwriting process, are established beginning in Section 1411 and subsequent sections of the Dodd-Frank Act.

On April 19, 2011, the Federal Reserve, as mandated by the Dodd-Frank Act, announced a proposed rule that would require all creditors or lenders to make a good faith estimate that a borrower has a reasonable ability to repay. The rule would also establish minimum mortgage underwriting standards.[3] The rule would expand ability-to-repay standards to cover all residential

[3] See http://www.federalreserve.gov/newsevents/press/bcreg/20110419a.htm. The rule was published in the *Federal Register* on May 11, 2011. See http://www.gpo.gov/fdsys/pkg/FR-2011-05-11/pdf/2011-9766.pdf. General rulemaking authority for the Truth-in-Lending Act (TILA; P.L. 90-321; 82 Stat. 146), which is implemented under Regulation Z, transfers to the CFPB on July 21, 2011. See CRS Report R41338, *The Dodd-Frank Wall Street Reform and Consumer Protection Act: Title X, The Consumer Financial Protection Bureau*, by David H. Carpenter.

mortgage loans. The Dodd-Frank Act transferred the authority to prescribe final regulations to the Consumer Financial Protection Bureau (CFPB) on July 21, 2011, and the closing date for comments was July 22, 2011. The CFPB has re-opened the comment period to seek further comments on the litigation risks that could potentially arise from the new requirements.[4] The comments, however, should be narrowly focused and based upon analysis that uses mortgage data from the portfolios of Fannie Mae and Freddie Mac, which are discussed in more detail below. The closing date for comments will be July 9, 2012. CFPB final rulemaking would not necessarily be bound by the Federal Reserve's proposed regulation.[5]

The proposed rule provides four methods in which a lender would be able to comply with the ability-to-repay standards. First, the originator can meet a general ability-to-repay standard by considering and verifying the following criteria: income or assets, current employment status, the size of the monthly mortgage payment, any monthly payment of subordinate or junior mortgages, the monthly payments of related mortgage expenses, other debt obligations, the monthly debt-to-income ratios, and credit history. In addition, creditors would be required to calculate the mortgage payment using the fully indexed rate. In other words, even if the borrower selects a nontraditional mortgage product with an initial lower interest rate, the adjustable interest rate plus the margin (the "mark-up" over the short-term interest rate index or constant amount added to the variable interest rate) must be used during underwriting. This compliance option does not place restrictions on the loan features, terms, or points and fees.

Second, a lender can be in compliance by refinancing borrowers out of nonstandard and into standard mortgage products. Standard mortgage products are defined as those without negative amortization features, interest-only payments, or balloon payments. They also have limits on points and fees. This compliance option allows for streamlined refinances that can quickly move borrowers out of higher risk mortgages and into ones with more stable payments. In addition, lenders would not have to verify the income and assets for borrowers being switched into standard mortgage products as long as their new monthly payments will be lower and they have not experienced delinquencies while paying their existing mortgages.

The third compliance option reduces regulatory burdens and legal liability exposure for originators and assignees holding "qualified mortgage" (QM) loans. The Federal Reserve proposed two alternative definitions for QMs given the inability to determine whether Congress intended the legal protection to be in the form of a *safe harbor* or a *rebuttable presumption*. The first definition, Alternative 1, operates as a *safe harbor*, which means that borrowers would not be able to assert that creditors failed to comply with any of the required underwriting criteria described below. The second definition, Alternative 2, operates as a *rebuttable presumption* of compliance, which allows borrowers to provide evidence that may possibly overturn a presumption of lender compliance even if the required procedures were followed.[6]

[4] See http://www.consumerfinance.gov/pressreleases/consumer-financial-protection-bureau-seeks-further-comment-on-ability-to-repay-mortgage-rule/ and http://files.consumerfinance.gov/f/201205_cfpb_Ability_to_Repay.pdf.

[5] See CRS Report R41839, *Limitations on the Secretary of the Treasury's Authority to Exercise the Powers of the Bureau of Consumer Financial Protection*, by David H. Carpenter, Limitations on the Secretary of the Treasury's Authority to Exercise the Powers of the Bureau of Consumer Financial Protection, by David H. Carpenter.

[6] For further description of the *safe harbor* and *rebuttable presumption* legal terms and interpretations, see Board of Governors of the Federal Reserve System, "Regulation Z; Truth in Lending," 76 *Federal Register* 27395-27396, May 11, 2011, at http://www.gpo.gov/fdsys/pkg/FR-2011-05-11/pdf/2011-9766.pdf.

The definition of a QM loan under Alternative 1 excludes mortgages with negative amortization features, interest-only payments, balloon payments, or terms that exceed 30 years. In addition, the total points and fees cannot exceed 3% of the total loan amount (for loans of $75,000 or more). The income and assets of the borrower must be verified. The underwriting of the mortgage must be based upon the maximum interest rate that might occur during the first five years, use a fully amortizing payment schedule, and incorporate other mortgage-related obligations such as escrows for property taxes. Under Alternative 2, lenders must still comply with all criteria listed under the first definition. In addition, employment status, credit history, debt-to-income ratio, and other debt repayment obligations must be considered during underwriting.

The final compliance option allows a lender to originate a balloon-payment QM in predominantly rural or underserved areas. A mortgage with a balloon payment is one in which regular payments are made for a period of time; but given that the payments include only partial or no amortization of the principal balance, the final payment that includes the remaining balance may be considerably larger. A balloon loan can be a QM as long as it is not a higher-priced loan, has a minimum term of five years, and the borrower must be qualified on the maximum possible payment that could occur over the first five years of the loan.[7]

## Risk-Retention Standards and Qualified Residential Mortgages

Title IX Subtitle D of the Dodd-Frank Act is entitled "Improvements to the Asset-Backed Securitization Process"; Section 941 is entitled "Regulation of Credit Risk Retention." This section requires securitizers to retain "not less than 5 percent of the credit risk for any asset that is not a qualified residential mortgage…" The Dodd-Frank Act authorizes the Federal Reserve and other financial regulatory agencies to implement requirements to ensure that relevant parties involved in a securitization transaction retain "skin-in-the-game" or a requirement to ensure the sharing of potential losses.[8] The legislation requires the agencies to jointly define the term *qualified residential mortgage*. The agencies must also take into consideration "underwriting and product features that historical loan performance data indicate result in a lower risk of default," including some factors cited in the legislation.

On April 29, 2011, six financial regulatory agencies published a proposed rule that would apply to securitized loans; the closing date for comments was August 1, 2011.[9] Securitizers would be required to retain at least 5% of the credit or default risk of the underlying mortgage assets that constitute the security.[10] The risk-retention requirement, however, would not apply to loans insured by the Federal Housing Administration (FHA) or the government-sponsored enterprises (GSEs) Fannie Mae or Freddie Mac while they are under conservatorship.[11] The securitizer may

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[7] The definition of a higher-priced or high-cost loan is discussed in the "Implications of QM and QRM Rules on Mortgage Credit Accessibility" section of this report.

[8] These requirements apply to nearly all asset classes, including securitizations of credit card loans, automobile loans, commercial real estate loans, and commercial (equipment) loans.

[9] The regulatory agencies were the Office of the Comptroller of the Currency (Department of the U.S. Treasury), the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the Securities and Exchange Commission, and the Department of Housing and Urban Development. See http://edocket.access.gpo.gov/2011/pdf/2011-8364.pdf.

[10] Securitizers may retain a 5% "vertical" slice of each payment class or a "horizontal" slice (or the first-loss position) of a mortgage-backed security pool. See the QRM rules at http://www.fdic.gov/news/board/29Marchno2.pdf.

[11] See CRS Report RL34661, *Fannie Mae's and Freddie Mac's Financial Problems*, by N. Eric Weiss.

also be exempted from the risk-retention requirement if the underlying assets meet the qualified residential mortgage (QRM) standards, which are stricter than the requirements for QM loans under the proposed rule.[12]

Mortgages exempted from the risk-retention requirements feature higher qualification requirements on borrowers. QRMs must be closed-end first-lien mortgages to purchase or refinance a one-to-four unit family property in which at least one unit is the principal residence of the borrower. In addition, homebuyers must also put down at least 20% of the purchase price in addition to paying the closing costs, 25% for standard mortgage refinancings, and 30% for cash-out refinancings that allow borrowers to extract equity from their homes.[13] Mortgages having such characteristics are exempt from risk-retention requirements given that the probability of default is significantly lower relative to mortgages in which borrowers have lower downpayments.

In addition, the definition of a QRM loan also excludes negative amortization features, interest-only payments, balloon payments, junior liens, prepayment penalties, or terms exceeding 30 years. The total points and fees cannot exceed 3% of the total loan amount. The income and assets of the borrower must be considered and verified. The underwriting of the mortgage must be based upon the maximum interest rate that might occur during the first five years, use a fully amortizing payment schedule, and incorporate other mortgage-related obligations, such as escrows for property taxes. For adjustable rate mortgages, the interest rates cannot increase more than 2% per year or 6% over the life of the loans. The employment status, credit history, debt-to-income ratio, and other debt repayment obligations of the borrowers must also be considered and verified. The borrowers' front- and back-end ratios must be at least 28% and 36%, respectively.[14] Borrowers cannot currently be 30 days past due on any loan obligation; have been 60 days delinquent on any loan obligation within the past two years; or be in bankruptcy, a short sale, foreclosure, or other federal or state judgment for the collection of any unpaid debts within the last three years. QRMs must be supported by written appraisals, and loan servicers must perform loss mitigation (or offer borrower workout options) in the event of default.

**Table 1** provides an abbreviated summary of differences between the QM and QRM requirements. As stated earlier, the QRM requirements for securitized mortgages that would be exempted from the risk-retention rule are stricter than the QM requirements.

[12] For complete tables with side-by-side comparisons of Alternatives 1 and 2 of the QM loans as well as QM with QRM loans, see http://www.philadelphiafed.org/bank-resources/publications/consumer-compliance-outlook/outlook-live/2011/052611.pdf and http://www.mbaa.org/files/ResourceCenter/MIRA/MBARiskRetentionRuleSummary.pdf.

[13] For a brief summary of the eligibility criteria for loans to meet the QRM standard, see http://www.fhfa.gov/webfiles/21113/RiskRetentionLawler41211.pdf.

[14] Typically, lenders set specific limits on borrower qualifying ratios or measures of borrower debt burden. The monthly mortgage payment to monthly (before tax) income ratio is known as the front-end ratio, and the monthly total debt payment to monthly (before tax) income ratio is known as the back-end ratio. Prime borrowers, who possess financial characteristics that indicate the ability to meet all scheduled payment obligations on time, typically have front- and back-end ratios that do not exceed 28% and 36%, respectively. The 28% and 36% qualifying ratios are standard for conventional loans, which follow guidelines established by Fannie Mae and Freddie Mac. For loans insured by the Federal Housing Administration (FHA), the front- and back-end ratios are set at 29% and 41%, respectively (see Mortgagee Letters 1989-25, 1997-26, and 2005-16, at http://www.hud.gov/offices/adm/hudclips/letters/mortgagee/).

**Table 1. Abbreviated Comparison of QM and QRM Requirements**

| Requirements | Qualified Mortgage (QM) | Qualified Residential Mortgage (QRM) |
|---|---|---|
| Banned Mortgage Product Features | Negative amortization loans, interest only, balloon payments | Negative amortization loans, interest only, balloon payments, junior liens, prepayment penalties |
| Points and Fees | May not exceed 3% of the total loan amount for loans of $75,000 or more | May not exceed 3% of the total loan amount |
| Underwriting at Fully Indexed Interest Rates | Loan must be underwritten using the maximum interest rate that would occur in the first 5 years after the loan becomes legally binding (usually at closing) | Loan must be underwritten using the maximum interest rate that would occur in the first 5 years after the first loan payment is due |
| Income or Assets | Consider and verify | Consider and verify |
| Employment Status | No specific requirement | Consider and verify |
| Front-end/Back-end Ratios | No specific requirement | 28%, 36% |
| Credit History | No specific requirement | Current on all debts; no 60 day delinquencies in past 2 years; no bankruptcies or foreclosures in past 3 years |
| Downpayment Requirements | No specific requirements | 20% home purchase; 25% standard refinance, 30% cash-out refinance |

**Source:** Philadelphia Federal Reserve Bank at http://www.philadelphiafed.org/bank-resources/publications/consumer-compliance-outlook/outlook-live/2011/052611.pdf

# Risky Mortgage Underwriting and Financing Practices (Type 1 Errors)

The typical errors that occur in mortgage lending can be characterized using a standard statistical framework.[15] Suppose a "type 1 error" occurs when borrowers who are likely to have repayment problems receive loans; a "type 2 error" occurs when borrowers who are likely to repay their loans on time are denied credit. In this context, extending credit to unqualified borrowers (type 1 errors) can translate into substantial costs to lenders and foster a rise in aggregate indebtedness that makes both borrowers and lenders vulnerable to a sudden weakening of economic conditions. On the other hand, not extending credit to qualified borrowers (type 2 errors) may translate into forgone profit opportunities for lenders, although there would be no realized losses. The consequences of making type 1 errors are considered worse for lenders (and taxpayers, should numerous mortgage defaults result in federal interventions designed to stabilize financial markets) than type 2 errors. The consequences of type 2 errors, however, include less credit availability for qualified borrowers, which may impede overall economic recovery. In short, the

[15] See U.S. Congress, House Committee on Financial Services, Subcommittee on Capital Markets and Government Sponsored Enterprises, *Statement of Henry V. Cunningham Jr., CMB*, Understanding the Implications and Consequences of the Proposed Rule on Risk Retention, 112th Cong., 1st sess., April 14, 2011, p. 8 at http://www.mortgagebankers.org/files/Advocacy/2011/MBATestimonyonRiskRetention.pdf.

framework illustrates a trade-off that exists between curtailing risky lending practices and borrower access to mortgage credit.

Various high-risk underwriting practices, such as collateral-dependent lending, low- or no-documentation loans, and failure to escrow for property taxes, were common prior to July 14, 2008.[16] Borrowers were also qualified for adjustable rate mortgages (ARMs) based upon the initial interest rate, which does not take into consideration that the loan rate applicable at the time of origination could increase. In addition, many mortgages were held in the portfolios of institutions that held little capital to buffer against a sudden multitude of defaults. Many participants involved in various stages of the securitized lending chain may have failed to perform the level of due diligence that could have revealed relaxed or inadequate underwriting standards. The lending practices discussed in this section arguably are associated with an increase in type 1 errors prior to the financial crisis. These practices or some variation thereof, which existed in prime and nonprime (and subprime) lending markets, allowed the balance sheets of many households and financial institutions to become highly leveraged with mortgage debt that could not be repaid under the economic and financial conditions that prevailed after loan origination.[17]

## Collateral-Dependent Lending

The term *collateral-dependent* lending was used to describe loans in which repayment depended more upon the current or expected future value of the housing assets rather than the borrowers' ability to repay using their incomes and savings. In other words, if borrowers lacked the income and other financial resources to meet repayment obligations, the sale of their homes would generate the funds to repay their mortgages. For example, suppose a borrower obtained a mortgage with an initial interest-only feature over a short period that might satisfy front- and back-end ratios at the time of origination. Once the interest-only period expired and principal amortization increased the monthly payments, the borrower may no longer satisfy the minimum front-end requirements. As long as house prices rose or did not substantially decline, the borrower could either refinance into another interest-only mortgage or sell the home at a price sufficient to satisfy the outstanding debt obligation. This practice allowed borrowers to take on large amounts of debt that could only be repaid under favorable economic conditions.

Collateral-dependent lending may also take the form of extremely low or zero downpayment lending. During the 2000s, piggyback or junior or secondary mortgage loans became a popular

[16] On July 14, 2008, the Federal Reserve issued final rules that prohibit collateral-dependent lending, require documentation of income, require escrowing for taxes, and prohibit other risky underwriting practices that affect higher-priced mortgage loans. The rule requires all lenders to consider borrowers' ability to repay any higher-priced mortgage loan. See http://www.federalreserve.gov/newsevents/press/bcreg/20080714a.htm. The Dodd-Frank Act codified many of these regulations in amendment form.

[17] The term *nonprime* lending may be an accurate characterization of lending that does not occur in traditional conventional or prime mortgage markets, although the term *subprime* has been adopted. Various developments in the mortgage markets contributed to the advance of nonprime lending. Beginning in the 1990s, credit increasingly became available for borrowers with weaker credit. Instead of turning down those loan requests, lenders began charging higher interest rates to compensate for the additional credit risk. Lending at higher costs relative to prime borrowers became known as subprime lending. In addition, structural trends in mortgage finance (i.e., decrease in the use of mortgage insurance, increase in home equity lending) that occurred during 2001 through 2005 led to fewer borrowers relying upon more traditional mortgage financing mechanisms, such as the FHA Hence, it would be misleading to characterize creditworthy borrowers that relied upon nontraditional mortgage financing arrangements or all nonprime borrowing as subprime. See Rajdeep Sengupta and William R. Emmons, *What is Subprime Lending?* Federal Reserve Bank of St. Louis, Economic Synopses, St. Louis, MO, 2007, http://research.stlouisfed.org/publications/es/07/ES0713.pdf.

financing alternative to purchasing mortgage insurance.[18] Piggyback loans offered borrowers at least two advantages. First, the interest on both the primary and secondary mortgages was tax deductible; until 2007, mortgage insurance premiums were not tax deductible.[19] Second, a borrower could transform a jumbo loan into two loans.[20] A conventional conforming loan, which normally would carry a lower interest rate than a jumbo loan, would serve as the primary loan and be combined with a secondary piggyback loan. Although secondary loans are likely to carry rates higher than jumbo rates, the smaller outstanding balance may cause the combined payments of the primary and secondary loans to be smaller than a jumbo payment with private mortgage insurance. The combined payment may be smaller still after factoring in both mortgage interest deductions, which would make the piggyback financing arrangement even more attractive to borrowers.[21]

The piggyback financing arrangement was also popular for borrowers that were not using mortgage credit to purchase homes.[22] "Cash-out refinances" allowed borrowers to pull most or all of the equity out of their homes to make home improvements, which might allow them to increase the marketability and profitability of their homes in the future. Borrowers with various student loan, automobile, credit card, or perhaps medical debts could also take advantage of rapidly rising house prices to consolidate these debts and ultimately reduce monthly payments, lower the interest costs, and improve their credit scores. Hence, while collateral-dependent lending in the form of cash-out refinances allowed some borrowers to speculate on house prices, it also served as a debt-consolidation mechanism that improved cash flow for some highly leveraged borrowers prior to the market decline.

Lien holders, however, grew more exposed to default risk as highly leveraged borrowers had less and less capacity to repay their debt obligations in the event of house price declines. An unexpected decline in house prices could cause borrower debt obligations to suddenly become greater in value than the underlying collateral secured by the loans, and the proceeds from a short or foreclosure sale would not be sufficient to repay loans in full. Underwriting mortgages based upon an assumption that favorable housing market conditions are indefinitely sustainable, therefore, would be considered a risky lending practice. Hence, lenders that relaxed their

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[18] See http://ofheo.gov/Default.aspx/webfiles/webfiles/14779/MMNOTE_09-04%5B1%5D.pdf.

[19] P.L. 109-432, the Tax Relief and Health Care Act of 2006, temporarily allowed mortgage insurance premiums paid for a personal residence to be tax deductible as mortgage interest for tax year 2007. P.L. 110-142, the Mortgage Forgiveness Debt Relief Act of 2007, extended that provision through December 31, 2010. See CRS Report RL33025, *Fundamental Tax Reform: Options for the Mortgage Interest Deduction*, by Pamela J. Jackson.

[20] A jumbo loan is defined as one having an amount that exceeds the maximum conforming loan limit. A conforming loan is one that Fannie Mae and Freddie Mac can purchase, which is why conforming loans typically carry lower interest rates than jumbo loans. See the jumbo-conforming mortgage loan rate spreads at http://www.banx.com/images/lazear08_ERP_BanxQuote_Chart_NE-Club-6_550pix.jpg and http://news.mortgagecalculator.org/wp-content/uploads/2010/03/Conforming-Jumbo-mortage-rate-spread.gif.

[21] The private mortgage insurance industry, along with the FHA, saw sharp declines in business as borrowers switched to using secondary mortgages to finance home purchases. See Federal Housing Finance Agency, State of the Private Mortgage Insurance Industry: Implications for the U.S. Mortgage Markets and the Enterprises, Mortgage Market Note 09-4, Washington, DC, August 20, 2009, http://ofheo.gov/Default.aspx/webfiles/webfiles/14779/MMNOTE_09-04%5B1%5D.pdf, p. 4 Chart 1; and Table 1: FHA Single Family Activity in the Home-Purchase Market Through March 2010 at http://www.hud.gov/offices/hsg/comp/rpts/fhamktsh/fhamkt_current.pdf.

[22] See Michael LaCour-Little, Eric Rosenblatt, and Vincent Yao, *Follow the Money: A Close Look at Recent Southern California Foreclosures*, Finance Department, California State University—Fullerton, Unpublished manuscript, May 2009, at http://www.areuea.org/conferences/papers/download.phtml?id=2133.

underwriting standards and relied on rising house prices for loan repayment arguably were speculating in the housing market alongside some borrowers.

The proposed QM rules may discourage lenders from excessively relaxing lending standards even during economic boom periods, thus making loan repayment more resilient to sudden shifts in short-term economic and financial conditions. Under the proposed definition of QRMs, lenders would be exempt from risk retention of any credit risk if the borrower has enough equity to avoid a piggyback financing arrangement. Hence, if the mortgage industry were to adopt a 20% downpayment requirement, then distressed borrowers might still be able to repay the outstanding mortgage balances by selling their homes particularly as long as house prices do not fall by more than 20%.

## Low- or No-Documentation Lending

Borrowers generally must provide proof of employment and income when applying for mortgage loans. A letter from an employer or copies of pay slips are typically acceptable ways of verification. Borrowers who are self-employed or paid on commission, however, may lack traditional verification documentation such as employer payment stubs. Hence, low- or no-documentation lending, which did not require traditional documentation but may have required some borrowers to meet higher downpayment requirements, may have benefitted borrowers with nonstandard employment circumstances.

"Low-doc" and "no-doc" loans have nevertheless become referred to as "liar loans" because the financial capacity of a borrower to repay a mortgage can be misrepresented either by the borrower, the lender, or both parties. Dishonest borrowers can mislead lenders, and lenders can intentionally or inadvertently mislead investors. Requiring full-income documentation reduces the likelihood that borrower repayment capacity will be exaggerated or misrepresented. Hence, low- or no-documentation lending is considered a risky underwriting practice.[23]

The increase in use of low- and no-documentation loans during the housing boom may be attributed to several factors. As credit scores evolved as a reliable predictor of default, lenders may have assigned new weights to the various borrower characteristics used when predicting default probabilities. For example, weights assigned to credit history may have increased simultaneously while the weights assigned to income declined.[24] Advances in automated underwriting technology may have influenced the underwriting process to allow for some higher-risk factors if sufficiently compensated by factors that were thought to reduce default risk.[25] In particular, rising house prices or collateral values may have acted as a compensating factor or hedge against borrower defaults. The rise in low- or no-documentation lending, therefore, may arguably be another manifestation of collateral-dependent lending. Given that low- or no-

[23] See CRS Report RL33775, *Alternative Mortgages: Causes and Policy Implications of Troubled Mortgage Resets in the Subprime and Alt-A Markets*, by Edward V. Murphy.

[24] See Table 2 in CRS Report RS22722, *Securitization and Federal Regulation of Mortgages for Safety and Soundness*, by Edward V. Murphy.

[25] For more information on automated underwriting and its adoption in the mortgage industry, see Robert B. Avery, Raphael Bostic, Paul S. Calem, and Glenn B. Canner, "Credit Risk, Credit Scoring, and the Performance of Home Mortgages," *Federal Reserve Bulletin*, vol. 82, no. 7 (July 1996), pp. 621-648; and Susan Wharton Gates, Vanessa Gail Perry, and Peter M. Zorn, "Automated Underwriting in Mortgage Lending: Good News for the Underserved?" *Housing Policy Debate*, vol. 13, no. 2 (2002), pp. 369-391.

documentation loans would not satisfy the income and asset verification requirements proposed QM and QRM rules, this lending practice would be discouraged.

## Qualifying Borrowers on Low, Unadjusted Interest Rates

During 2004-2006, nontraditional loans, as compared with the traditional or standard 30-year fixed rate mortgages, were common. Many of these loans were ARMs with initially low or "teaser" rates; some also had interest-only periods, during which the borrower's payment did not reduce the principal balance of the loan. Even if interest rates do not rise, interest-only loans eventually will have higher payments once the principal repayment period starts. Mortgages with two- or three-year introductory periods, known as 2/28s and 3/27s, proliferated between 2005 and 2006, in particular in the subprime market. "Option ARMs," also called negative amortization loans, would allow borrowers to pay less than the current interest due and also result in higher outstanding debt balances for borrowers choosing to pay only the monthly minimum in the introductory period.

Borrowers can benefit from nontraditional mortgage products if they do not intend to stay in the mortgage for a full 30 years and want to reduce their monthly payments. The required monthly payments on these products are usually lower for an introductory period of time, and the borrower may plan to refinance the mortgage or sell the home before the deferred interest or principal (that would have been paid under a traditional mortgage) becomes due. Hence, nontraditional mortgage products may increase affordability and *reduce* potential repayment problems in some circumstances for borrowers, in particular those who diligently build liquid reserves by saving the difference between the traditional fixed rate and nontraditional mortgage payments (assuming the nontraditional payment is lower).

Nontraditional mortgages, however, are more susceptible to repayment problems associated with sudden changes in financial and economic circumstances. For example, mortgage loans payments that were tied to short-term LIBOR increased after a sudden spike in LIBOR rates in 2008.[26] In addition, repayment problems would be exacerbated for borrowers who lacked sufficient precautionary liquid assets. Borrowers who marginally qualify for nontraditional loans at initially low rates (that may not even include the lender "mark-up" or margin) that would prevail for only a short period of time may be especially vulnerable to future repayment problems. Hence, extending credit with the presumption that the initial interest rates will not rise significantly over the period borrowers are expected to stay in the loan contracts would be considered a risky lending practice. The proposed QM rule requires using the fully indexed interest rate during underwriting, and thus discourages the practice of qualifying borrowers at initially low rates.

## Failure to Escrow for Property Taxes

When property taxes are included as part of the mortgage underwriting process, it reduces the likelihood that borrowers are unprepared to pay when tax bills come due. Some first-time home

[26] LIBOR stands for the London Interbank Offered Rate, which represents the global benchmark costs (interest rates) that banks and other financial entities pay to borrow unsecured funds from each other. A substantial amount of subprime mortgages were linked to LIBOR. For more information, see http://www.clevelandfed.org/research/commentary/2009/012109.cfm and http://www.marketwatch.com/story/short-term-rates-jump-on-libor-spike-fed-rethinking.

buyers, in particular, may not understand that property taxes are assessed annually, so a tax bill might find them unprepared. Repayment problems are often triggered by some unanticipated expense.[27] Similarly, a lack of preparedness to pay property taxes may leave some borrowers vulnerable to default. Hence, failure to escrow for property taxes is an underwriting practice that may lead to overestimating the borrowers' ability to repay.

Factoring the ability to pay property taxes may not have been standard underwriting practice in subprime lending in light of its origins as a cash-out refinance market. Many borrowers used subprime loans to access existing home equity for consolidating and perhaps reducing overall monthly debt payments, making home improvements, and purchasing durables.[28] Subprime lenders, while catering to this market segment, may not have incorporated property tax escrows because it is not common practice for many cash-out refinances. Nevertheless, escrowing for property taxes was arguably overlooked for those borrowers who leveraged themselves near the limits of their capacity to repay loans. Hence, the proposed QM rule addresses this problem by requiring the incorporation of escrows and other mortgage related payment obligations in the underwriting process.

## Low Capital Buffers

Safety and soundness regulation generally requires financial institutions to hold a certain percentage of capital to withstand a surge in loan defaults. If financial institutions have sufficient capital buffers to absorb losses from nonperforming loans, then insolvency and subsequent failures, which imposes economic costs and threatens overall financial stability, are less likely to occur.[29] For bank depository institutions to be considered adequately capitalized, they must have total risk-based capital ratios equal to or greater than 8%.[30] For credit unions to be adequately capitalized, they must have net worth, which is analogous to bank capital ratios, between 6% and 6.99%.[31]

Large complex financial institutions sponsored financial conduits that allowed mortgages to be financed off the balance sheets of supervised banks.[32] In other words, the conduits could issue debt obligations (e.g., short-term commercial paper) to investors without being subject to

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[27] See Darryl E. Getter, "Contributing to the Delinquency of Borrowers," *The Journal of Consumer Affairs*, vol. 37, no. 1 (2003), pp. 86-100.

[28] Home equity lending during this time period was available to prime borrowers. Borrowers with impaired credit had few alternatives if they also wanted to consolidate debt obligations or make home improvements. FHA does not insure home equity loans, and its cash-out refinance program requires borrowers to have an 85% loan-to-value ratio after refinancing.

[29] See CRS Report R40417, *Macroprudential Oversight: Monitoring Systemic Risk in the Financial System*, by Darryl E. Getter.

[30] See table entitled "Risk-Based Capital Groups" at http://www2.fdic.gov/qbp/2011jun/qbp.pdf.

[31] See Statutory Net Worth Categories at http://www.ncua.gov/GenInfo/GuidesManuals/examiners_guide/chapters/chapter17.pdf.

[32] Some critics argue that such off-balance sheet activities would not have been able to occur if banks had not been given permission to participate in a wider variety financial activities. See Thomas M. Hoenig and Charles S. Morris, *Restructuring the Banking System to Improve Safety and Soundness*, Federal Reserve Bank of Kansas City, May 2011, http://www.kansascityfed.org/publicat/speeches/Restructuring-the-Banking-System-05-24-11.pdf. For more information on the supervision of Large Complex Banking Organizations, see Lisa M. DeFerrari and David E. Palmer, "Supervision of Large Complex Banking Organizations," *Federal Reserve Bulletin*, February 2001, pp. 47-57 at http://www.federalreserve.gov/pubs/bulletin/2001/0201lead.pdf.

traditional banking safety and soundness capital requirements given that the mortgages were not held in bank portfolios. Prior to the Dodd-Frank Act, nonbank (nondepository) institutions, as well as the nonbank subsidiaries of bank holding companies, could originate mortgages that would not be subject to regulatory capital requirements. Hence, mortgages could be funded with less capital, and the extent to which this was done arguably reflects overconfidence in the performance of mortgage assets that ultimately stemmed from overconfidence in rising house values.[33] Such lender overconfidence made it possible for borrowers to gain access to credit, which translates into greater type 1 errors. The proposed QM and QRM rules do not directly address issues related to inadequate capital buffers to absorb a sudden rise of delinquencies; however, the Basel Committee on Banking Supervision has called for increased capital buffers for banks[34], and the Dodd-Frank Act also requires minimum capital requirements for banks.[35]

In addition, mortgage financiers or securitizers who purchased mortgages from loan originators, including the GSEs Fannie Mae and Freddie Mac held relatively little capital to support their mortgage lending activities. Prior to conservatorship, the GSEs were classified as adequately capitalized when they met the statutory minimum requirement of 2.5% for loans that they kept in portfolio and only 0.45% for off-balance sheet obligations despite their exposures to credit risk.[36] Given statutory requirements that allowed for highly leveraged and undiversified asset portfolios, the GSEs were as vulnerable as other mortgage borrowers and lenders to a “Minsky moment” or sudden financial downturn in which existing assets cease to generate revenues sufficient to cover financial repayment obligations.[37]

## Inadequate Due Diligence in Securitization Pipelines

A mortgage securitization transaction typically involves an originator that sells a mortgage loan to a securitizer, who then issues mortgage-backed securities (MBSs) to investors. The credit risks of the assets used to create structured finance securities are considered opaque by experts and regulators.[38] Despite general documentation about the type of underlying risk exposures and credit ratings, the lack of secondary market trading information (as a result of the infrequent trading of structured finance offerings) and access to loan-level information on the underlying MBS collateral hinder full transparency.

Given the inherent opacity of securitization, all participants of a securitization process might be inclined to perform their own due diligence examinations of the underlying credit risks rather than rely solely upon the assessments of other parties in the pipeline.[39] Investors, however, may

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[33] See Christopher L. Foote and Paul S. Willen, “The Subprime Mortgage Crisis,” in *The New Palgrave Dictionary of Economics Online*, eds. Steven N. Durlauf and Lawrence E. Blume, Online Edition ed (Palgrave Macmillan, 2011).

[34] For information about Basel III, see http://www.bis.org/bcbs/basel3.htm.

[35] See P.L. 111-203, Title I, Subtitle C, Section 171 entitled “Leverage and Risk-Based Capital Requirements.”

[36] See “Capital Prior to Conservatorship” at http://www.fhfa.gov/Default.aspx?Page=146 and CRS Report R40800, *GSEs and the Government’s Role in Housing Finance: Issues for the 112th Congress*, by N. Eric Weiss.

[37] See speech by then Director of the Office of Federal Housing Enterprise Oversight, James B. Lockhart III, at http://www.fhfa.gov/webfiles/1444/AmBar8906speech.pdf.

[38] See Bobby R. Bean, *Enhancing Transparency in the Structured Finance Market*, Division of Supervision and Consumer Protect, Federal Deposit Insurance Corporation, Supervisory Insights, at http://www.fdic.gov/regulations/examinations/supervisory/insights/sisum08/article01_transparency.html.

[39] See Malcolm D. Knight, “Securitisation: Was the Tail Wagging the Dog?,” Speech delivered at 33rd Annual Conference of the International Organization of Securities Commissions, Bank for International Settlements, May (continued...)

have relied too heavily upon credit rating agencies, who may have relied too heavily upon securitizers, who may rely too heavily on mortgage originators to identify the level of risk exposure to borrower repayment problems under deteriorating economic conditions.[40] Consequently, an "incentive misalignment" problem arguably exists when the participants of a securitization pipeline do not all share the incentive to perform due diligence to determine the credit quality of the underlying mortgages.[41] Incentive misalignment problems tend to increase during periods of excessive optimism and foster the proliferation of type 1 errors. Furthermore, inadequate due diligence among securitization participants also reduces the likelihood of detecting deceptive or predatory lending practices. Requiring one or more of the parties in a securitization pipeline to retain "skin-in-the-game," which is the purpose of the propose QRM risk-retention rules, would arguably provide the incentive to perform due diligence examinations.[42]

# Implications of QM and QRM Rules on Mortgage Credit Accessibility

The mortgage lending practices that occurred prior to the financial crisis resulted in excessive leveraging that many believe impedes the current economic recovery. The QM rules would increase standards such that borrowers may experience fewer repayment problems after a sudden downturn in economic and financial conditions. The QRM rules, which would require the sharing of any eventual losses associated with nonperforming mortgage loans, would encourage greater due diligence in the underwriting process. The ability to repay and risk-retention measures, therefore, address the proliferation of risky financial practices that are associated with a rise in type 1 lending errors.

Industry experts, however, fear that the QRM standards, which would provide an exemption from risk-retention requirements, might become widely adopted and translate into a sharp increase in type 2 lending errors.[43] Comments on the proposed rules from mortgage industry representatives

(...continued)

2008, http://www.bis.org/speeches/sp080602.htm.

[40] See The Financial Crisis Inquiry Commission, *Final Report of the National Commission of the Causes of the Financial and Economic Crisis in the United States*, January 2011, pp. 157-174, http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf.

[41] Due diligence examination of the thousands of mortgages that would comprise a MBS, however, is costly, which may explain why participants of a securitization pipeline relied upon the due diligence efforts of other participants. For example, the senior investors of a securitization, who are first to receive the generated cash flows, theoretically may not need to perform the same level of due diligence as more junior investors, who are repaid last. In other words, investors choose a particular type of securitization payment structure or purchase other forms of credit enhancements to substitute for more costly due diligence. Hence, characterization of the failure to perform due diligence by all participants of a securitization pipeline as an incentive misalignment problem is still being debated among academics. See Gary Gorton, "Slapped in the Face by the Invisible Hand: Banking and the Panic of 2007," Federal Reserve Bank of Atlanta 2009 Financial Markets Conference: Financial Innovation and Crisis, Atlanta, GA, May 9, 2009, http://www.frbatlanta.org/news/Conferen/09fmc/gorton.pdf.

[42] See John Kiff and Michael Kisser, "A Shot at Regulating Securitization," Regulation of Systemic Risk, A conference sponsored by the Federal Reserve Board and the Journal of Money, Credit, and Banking, Washington, DC, September 9, 2011, http://www.federalreserve.gov/events/conferences/2011/rsr/papers/KiffKisser.pdf.

[43] See Knowledge@Wharton, *Revitalizing the Private Mortgage Market: 'Skin in the Game' and the Consequences for Future Homebuyers*, May 11, 2011, http://knowledge.wharton.upenn.edu/article.cfm?articleid=2775 .

express a preference to hold loans that satisfy specific (quantitative) measures that can be documented at origination and are less likely to be contested in court or by a regulator.[44] Furthermore, smaller community banks that typically serve as mortgage brokers and sell many of their mortgage originations may choose not to increase their required regulatory capital levels to retain non-QRMs in their portfolios. Consequently, in light of the heighted legal risks, industry representatives also favor harmonization of both the QM and QRM rules into one definition, which may reduce possible incidents of inconsistent interpretations among participants in the securitization pipeline as well as the financial regulators.[45]

The restrictions on points and fees along with the change in the definition of a high-cost mortgage loan would reduce the profitability of "risk-based" pricing or the practice of charging riskier borrowers more to offset their greater levels of default risk. Disadvantaged or weaker borrowers, therefore, would face additional difficulties obtaining mortgage credit. First, the Dodd-Frank Act amended the definition of a high-cost mortgage loan as well as the calculation of points and fees that apply to these loans.[46] A high-cost mortgage loan is defined as one that is greater than $20,000 and has points and fees that exceed 5% of the total loan amount for loans (or exceeds $1000 for loans that are less than or equal to $20,000). Second, the definition of points and fees would include all compensation paid to a loan originator (i.e., origination, underwriting, and broker's fees), prepayment penalties, and upfront mortgage insurance premiums in excess of the amount payable under FHA provisions. [47] Such definition changes increase the likelihood that some low-credit quality borrowers would not meet the QM or QRM standards or hit the trigger that makes high-cost mortgage loans less attractive to originate.[48] Consequently, the proposed standards may result in legal protection provided to creditors when they originate loans to borrowers of lower-default risk as opposed to higher-risk borrowers. Legal protection, however, would arguably be more beneficial to creditors when lending to disadvantaged borrowers.

Hence, while meeting the QRM standards may reduce the type 1 errors associated with allowing financially unqualified borrowers to accumulate large debt levels, the rejection of applicants able to repay non-QRMs may rise. The consequences of type 2 errors may include less credit availability for qualified borrowers, which can impede overall economic recovery. Type 2 errors or forgone lending opportunities are also likely to become more apparent during times when financial and macroeconomic conditions are more favorable toward loan repayment.

The ability to repay and risk-retention rules may lead to a shift of more mortgage credit risk from the financial markets to the federal government. For example, the Federal Housing

[44] For example, see comment letters at http://www.mbaa.org/files/Advocacy/2011/RiskRetentionBrochure.pdf, http://nationalmortgageprofessional.com/sites/default/files/SIFMA_Letter_07_11.pdf, and http://www.americansecuritization.com/uploadedFiles/ASF_Comments_on_Ability_to_Repay_QM_Proposed_Rule_7_22_11.pdf.

[45] See comments by the Securities Industry and Financial Markets Association at http://www.federalreserve.gov/SECRS/2011/July/20110728/R-1417/R-1417_072211_84017_480101591206_1.pdf.

[46] For the definition of a high-cost loan as defined under the 1994 Home Ownership Equity and Protection Act (P.L. 103-325, HOEPA) prior to the Dodd-Frank Act, see CRS Report RL34720, *Reporting Issues Under the Home Mortgage Disclosure Act*, by Darryl E. Getter.

[47] Discounts points associated with lowering the mortgage rate or fees paid to third party settlement service firms would be excluded from the definition of points and fees. For a summary of changes to HOEPA's definitions and requirements, see http://www.freddiemac.com/learn/pdfs/uw/Pred_requirements.pdf.

[48] See comments by the American Securitization Forum on the proposed QM rules at http://www.americansecuritization.com/uploadedFiles/ASF_Comments_on_Ability_to_Repay_QM_Proposed_Rule_7_22_11.pdf.

Administration, which currently has a downpayment requirement of 3.5%, may become a more affordable option should higher downpayment requirements be adopted by the mortgage industry. An increase in FHA business would mean that the federal government would insure a larger share of mortgage originations in the United States. On the other hand, while the GSEs, which securitize a significant share of U.S. mortgages, remain under conservatorship, the QRM downpayment requirements are unlikely to affect borrowers. The QRM standards, therefore, may not necessarily translate into type 2 errors or significant reductions in credit availability as long as the federal government bears the default risk for low downpayment mortgage loans.

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