Meeting with Representatives of the Center for Responsible Lending

On March 21, 2013, members of FHFA staff met with representatives from the Center for Responsible Lending (CRL), who presented CRL view that the definition of "qualified residential mortgage" should be conformed to the "qualified mortgage" standard. FHFA was also given CRL's Issue Brief (attached) on this matter.

CENTER FOR RESPONSIBLE LENDING

Regulators Should Conform the Qualified Residential Mortgage Definition to the Qualified Mortgage Standard

CRL Issue Brief March 20, 2013

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). This would fulfill two important policy objectives:

- Because the QM standard already excludes mortgages with risky features that have a higher propensity to default and requires affordability, the benefits of layering on a down payment restriction in reducing default rates would be low.

- 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 means to repay their mortgages.

Regulators should apply the same definition used for QM loans to QRM loans, and thereby maintain access to credit for low-risk privately-securitized loans while also requiring skin-in-the-game when non-QM mortgages with risky features are packaged into private-label securities.

In addition, 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. Further, aligning the two standards would lessen the regulatory complexity that lenders face in dealing with two overlapping but different rules at a time when lenders must implement a number of significant new mortgage rules, a particularly important issue for smaller lenders. Finally, given that QM includes GSE loans, layering on additional requirements only for privately securitized loans will put private capital at a disadvantage and make it more difficult to restart the private securitization market.

1. Because the QM standard already excludes mortgages with risky features that have a higher propensity to default and requires affordability, the benefits of layering on a down payment restriction in reducing default rates would be low.

The QM rulemaking addresses 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, loans must be fully documented by the lender. QM loans are limited to thirty

[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).

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 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.

Additional lending requirements should not be layered on top of the QM standard for purposes of determining which mortgages require risk retention. Data demonstrates that restricting risky product features alone has a significant impact on reducing estimated 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. It found that mortgages meeting QM product requirements[3] had a default rate of 5.8 percent through February 2011, compared to a default rate of 11.0 percent for the entire study sample.[4] This default rate was also lower than the 7.7 percent default rate for prime conventional loans, and much lower than the rate for Alt A (22.3 percent) and subprime (32.3 percent) loans.[5]

Furthermore, because the QM definition requires either meeting a DTI cut-off or adherence to agency underwriting criteria, the QRM definition should not also include a down payment requirement that further restricts access to mainstream credit. 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. The *Balancing Risk and Access* study suggests that the additional DTI factor will further reduce estimated default rates and will also restrict some households from obtaining a loan that meets QM status.[6] Layering on a down payment requirement in addition to the QM product features and the 43 percent DTI cut-off or GSE underwriting will provide a limited incremental benefit in reducing estimated default rates. When looking at loans that already meet the QM product restrictions – but without including the 43 percent DTI limit or GSE underwriting – *Balancing Risk and Access* found that requiring a 10 percent down payment rather than no down payment reduces the overall default rate from 5.8 percent to 4.7 percent.

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[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*, Center for Community Capital and Center for Responsible Lending, at 13 (Revised March 5, 2012). (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.").

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

[5] *Id.*

[6] *Id.*, at 19.

This is a marginal benefit to begin with, and would likely be even less when the 5.8 percent is already reduced by factoring in the DTI or GSE aspect of the QM definition as well.

2. **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 means 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.[7] 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 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.[8]

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-

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

income borrowers and borrowers of color.[9] Communities of color have lost considerable wealth as a result of the subprime lending boom and the resulting foreclosure crisis.[10] 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 2010 median housing prices and incomes, it would take over *20 years* for the average family to save a 10 percent down payment plus closing costs, as well as 13 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 *31 and 26 years*, respectively, to save enough to meet a 10 percent requirement and *20 and 16 years*, respectively, for a 5 percent requirement.[11]

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

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. By excluding so many families from accessing affordable mortgages,

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[9] 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 inaccurate delinquency proxy for a credit score of a certain number – to the QRM definition.

[10] *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).

[11] Based on purchase of a 2010 median priced house ($158,100) by borrower with median household income in 2010 ($50,046). We assume an annual savings rate dedicated for down payment of 2%. Median income for 2010 is from American Community Survey. Our savings rate assumption is derived from the Bureau of Economic Analysis's annual savings rate for April 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.

beyond what the market itself would require, a down payment requirement for federally-supported mortgages 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 actually undermine its primary objective of reducing individual default rates.

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. 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. Finally, given that QM includes GSE loans, layering on additional requirements only for privately securitized loans will put private capital at a disadvantage and make it more difficult to restart the private securitization market.