December 1, 2021

MEMORANDUM TO: Board of Directors

FROM: Doreen R. Eberley
Director
Division of Risk Management Supervision

SUBJECT: Credit Risk Retention Rule
Determination – Qualified Residential Mortgage and Related Exemptions

Summary and Recommendation

Staff recommends that the FDIC Board of Directors (the "Board") (i) approve the determination of the review of the definition of qualified residential mortgage ("QRM") and certain exemptions relating to residential mortgage securitizations under the Credit Risk Retention Rule (as defined below); and (ii) approve publication in the *Federal Register* of notice of such determination, substantially in the form of Attachment 1 (the "Notice").

I. **Background**

In late 2014, six agencies (the FDIC, the Office of Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Securities and Exchange Commission, the Federal Housing Finance Agency, and the Department of Housing and Urban Development (the "Agencies")) adopted the credit risk retention regulations (the "CRR Rule").[1] The CRR Rule generally requires that sponsors of securitization transactions retain a portion of the credit risk of the securitized assets. The CRR Rule exempts securitizations

[1] The CRR Rule, as adopted by the FDIC, is codified at 12 C.F.R. Part 373.

consisting entirely of QRMs and certain related assets.[2] A QRM is defined in the CRR Rule as a qualified mortgage ("QM") as defined by the Consumer Financial Protection Bureau ("CFPB") under the Truth in Lending Act ("TILA") and Regulation Z promulgated thereunder.[3]

The CRR Rule also exempts from the credit risk retention requirements securitizations consisting entirely of community-focused residential mortgages (defined in the CRR Rule as residential mortgages exempt from the definition of "covered transaction" under certain provisions of the CFPB's Regulation Z) and certain related assets (the "Community Mortgage Exemption"),[4] and securitizations consisting entirely of three-to-four unit residential mortgage loans (as defined in the CRR Rule) and certain related assets, or securitizations consisting of three-to-four unit residential mortgage loans (as defined in the CRR Rule) together with QRMs, and certain related assets (the "Three-to-Four Unit Mortgage Exemption").[5]

Section _.22 of the CRR Rule requires the Agencies, not later than December 24, 2019, to commence a review of the definition of QRM, the Community-Mortgage Exemption, and the Three-to-Four Unit Mortgage Exemption (collectively, the "Review"). The CRR Rule also requires the Agencies to review these provisions again five years following the completion of the initial Review and every five years thereafter, and requires a Review at any time an Agency

[2] 12 CFR §373.13(b).
[3] 12 CFR §373.13(a).
[4] 12 CFR §373.19(a).
[5] 12 CFR §373.19(a).

requests (each, a "Future Review"). In accordance with this requirement, the Agencies began the Review in Fall 2019.

The CRR Rule also requires that the Agencies publish notice of the commencement of the Review in the *Federal Register* and, after completion of the Review, but not later than six months after the publication of the notice announcing commencement of the Review (unless extended by the Agencies), publish notice disclosing the determination of the Review.

The Agencies published notice of the commencement of the Review on December 20, 2019 (the "Review Commencement Notice"). On June 30, 2020, the Agencies published notice announcing their decision to extend to June 20, 2021, the period for completion of the Review and publication of notice disclosing determination of the Review. On July 22, 2021, the Agencies published another notice announcing their decision to extend the period to complete and publish notice of determination of the Review further, to December 20, 2021. Accordingly, the Agencies are due to publish notice of their determination of the Review by December 20, 2021.

II. Completion of Agency Deliberations and Determination

Summary and Recommendation

FDIC staff together with staff of the other Agencies completed their analysis. In doing so and reaching its conclusions, Agency staff considered what has been learned since 2014 about whether the loan and borrower characteristics specified in the QRM definition are predictive of a lower risk of default. Agency staff also assessed how mortgage credit access conditions have changed since 2014, using data from the date on which the CRR Rule was announced, October 22, 2014, through December 31, 2019 (the "Review Period"). Among other things, staff analyzed data from Fannie Mae and Freddie Mac (the "Enterprises") and other loan origination and performance data (including data on defaults, and loan and borrower characteristics), held discussions with market participants, and reviewed academic research, policy research prepared by research and advocacy organizations, and the results of the CFPB's Ability-to-Repay and Qualified Mortgage Rule Assessment Report issued in 2019.[6]

Agency staff concluded, based on this analysis, that the loan and borrower characteristics specified in the QM definition in effect during the Review Period were predictive of a lower risk of default. Staff's analysis also considered the effects of additional loan and borrower characteristics on default risk. In addition, staff found that, while credit conditions have improved since 2014, they remain tight relative to longer-term norms. Based on this analysis, staff from each Agency participated in drafting the Notice, which sets forth the Agencies' decision that no change be made to the definition of QRM, the Community-Mortgage Exemption, or the Three-to-Four Unit Mortgage Exemption.

FDIC staff understands that staff of each other Agency is recommending that its respective Agency approve publication of the Notice. FDIC staff participated with other Agency staff in analyzing the data and reaching conclusions based on the analysis and in drafting the Notice, and concurs with the analysis and conclusions of the Agency staff group.

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[6] Available at https://files.consumerfinance.gov/f/documents/cfpb_ability-to-repay-qualified-mortgage_assessment-report.pdf.

Accordingly, FDIC staff is recommending that the Board approve the determination of the Review as set forth in the Notice and publication of the Notice.[7]

Discussion

Public Comments. In response to the notice of commencement of the Review, which included a request for comment, the Agencies received only one comment (on behalf of 37 parties describing themselves as financial services, real estate finance, housing, consumer affairs, and civil rights organizations) prior to the end of the comment period (which ended on February 3, 2020) and a second comment in June 2021. The comment received during the comment period requested that the Agencies defer the Review until after the CFPB completed its then-proposed rulemaking to make changes to the QM definition to ensure that the Review was "comprehensive and meaningful".[8] While the Review was delayed by the Agencies, it was delayed for various reasons unrelated to the pendency of the CFPB changes, including disruptions precipitated by the Covid-19 pandemic. The Review was not delayed in order to review the final CFPB QM changes, as the CRR Rule requires the Review to consider the definition of QRM in light of changes in the mortgage and securitization market conditions and practices and how the QRM definition affected residential mortgage underwriting and securitization of residential mortgage loans under evolving market conditions during the

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[7] In this connection, FDIC staff notes that the CRR Rule requires the Agencies to conduct a review of the subject residential mortgage provisions upon the request of any agency, specifying the reason for such request. Accordingly, the Agencies may conduct a further review of the subject residential mortgage provisions at any time.

[8] The letter noted that an advance notice of proposed rulemaking had been issued by the CFPB and that the CFPB was expected to follow with a notice of proposed rulemaking.

Review Period. The CRR Rule does not contemplate a delay in the Review on account of pending, prospective changes to the QM definition.

The CFPB did not issue the final QM changes until December 10, 2020. Those changes did not become effective until March 1, 2021 (well after the Review Period), and were subsequently revised on April 27, 2021. FDIC staff nonetheless reviewed what were, at the time of the Review, the CFPB's proposed changes to the general definition of a QM (in particular the change from a definition based, in part, on debt-to-income (DTI) to one based on loan pricing).[9] Based upon the information provided by the CFPB to support the changes,[10] staff concluded that these changes, if implemented, were not likely to significantly affect the overall impact of the QRM definition on the mortgage market.

The second comment letter (on behalf of six trade organizations) expressed support for the continued alignment of the definitions of QRM and QM.[11]

Definition of QRM. The Agencies' decision in 2014 to define QRM as QM in the CRR Rule was based on two main factors. First, the Dodd-Frank Act mandated that the definition of QRM "tak[e] into consideration underwriting and product features that historical loan

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[9] The CFPB changes, as adopted and subsequently revised, replace the DTI criterion with a criterion based on loan pricing, and add a new exemption for certain seasoned loans (i.e., outstanding for more than three years). Because the CRR Rule adopts the QM definition as the definition of QRM, the CFPB's changes to QM also effect changes to the definition of QRM. The change to permit certain seasoned loans to qualify as QM became effective on March 1, 2021, but seasoned mortgages will not qualify as QM until at the earliest March 1, 2024 (after the three-year holding period). The CFPB finalized the changes to the general QM definition, effective on March 1, 2021. However, in late April of 2021, the CFPB delayed the mandatory compliance date to October 1, 2022. Between March 1, 2021, and October 1, 2022, creditors have the option of using either the old, DTI-based general QM definition or the new, price-based definition.

[10] 85 FR 86308 (December 29, 2020).

[11] While this comment letter also praised the Agencies for delaying the issuance of the Review determination until the CFPB changes were finalized, as noted above, the Agencies did not delay the issuance of their determination to consider those changes as those changes occurred outside of the Review Period.

performance data indicate result in a lower risk of default." Second, the Dodd-Frank Act specified that the QRM definition could not be broader than the QM definition, and the Agencies were concerned that a QRM definition that was narrower than the QM definition could exacerbate already-tight mortgage credit conditions.

In the Review, staff considered whether the loan and borrower characteristics specified in the QM definition, as in effect during the Review Period, are predictive of a lower risk of default and how mortgage credit conditions have changed since 2014. Staff confirmed that the QRM definition that was in effect for the Review Period – with the requirement that DTI ratios generally not exceed 43 percent – was predictive of lower default rates.

Staff reviewed loan level mortgage origination and performance data on Enterprise and non-Enterprise loans in the Review.[12] Staff followed the performance of loans originated between 2012 and 2015 and found that, after four years, loans with a DTI ratio greater than 43 percent were more likely to have become 90-days delinquent than loans with lower DTI ratios. Staff also confirmed that the measurement of DTI had improved, with more full documentation mortgage loans in 2019 than in 2014. In the Review, staff also considered the effects of additional loan and borrower characteristics on default risk.[13]

Staff also considered whether QRM defined as QM, affected the availability of credit during the Review Period. While credit conditions had improved since 2014, staff concluded

[12] Mortgage servicing data from the Enterprises was used for this analysis, and the Commission staff contributed its analysis using mortgage servicing data from CoreLogic.

[13] Staff confirmed that loan-to-value (LTV) ratio and credit score, which the Agencies considered in the 2014 rulemaking but did not incorporate into the QRM definition, also predict default.

that they remained tight relative to longer-term norms.[14] However, staff determined that the QRM definition did not appear to be a material factor in credit conditions during the Review Period, in part because so much of the market was funded through the Enterprises and by Ginnie Mae securitizations.[15] More generally, staff concluded from the Review that risk retention remains an effective tool for aligning the interests of securitizers, originators, and investors, and reducing default risk on certain loans, and that the CRR Rule did not appear to be weighing materially on mortgage credit availability.

Finally, staff considered whether QRM, defined as QM, affected the securitization market. As anticipated, staff concluded that the QRM definition contributed to the bifurcation of the private-label securitization market between "prime/jumbo" securitizations (which typically meet the characteristics of QM and are, therefore, exempt from risk retention as QRM) and "non-QM" securitizations that are not QRM (and, therefore, generally not exempt from risk retention). However, according to industry sources, the market for non-QM securitizations was quite competitive through the end of 2019, which suggests that risk

[14] Measures of mortgage credit availability, such as those produced by the Urban Institute, suggest that credit during the Review Period was tight relative to levels in the early 2000s.

[15] The Enterprises are subject to risk retention, but benefit from a provision in the CRR Rule that allows their full guarantee of principal and interest on mortgage backed securities to count as an eligible form of risk retention while they are under conservatorship or receivership and have capital support from the U.S. Treasury. In contrast to the Enterprises, Ginnie Mae, a wholly owned U.S. Government corporation within HUD, is exempt from risk retention pursuant to statutory direction in the Dodd-Frank Act. See 15 U.S.C. §78o-11(c)(1)(G)(ii) and (e)(3)(B). According to estimates by Inside Mortgage Finance and the Urban Institute, the annual share of the dollar volume of first-lien mortgage originations that were either acquired by the Enterprises or securitized through an FHA or VA program has ranged from about 62 to 76 percent over the period 2015 to 2020 (https://www.urban.org/sites/default/files/publication/104602/july-chartbook-2021_2.pdf).

retention did not materially affect the ability of issuers in this market to obtain capital needed for mortgage originations.[16]

Community Mortgage Exemption. Community-focused residential mortgages are mortgages made by community development financial institutions (CDFIs), community housing development organizations, certain non-profits, or certain secondary financing providers, or through a state housing finance agency ("HFA") program. These entities frequently make mortgage loans using flexible underwriting criteria that are not compatible with the TILA ability-to-repay requirements. To ensure continued borrower access to these loan programs, the CFPB exempted these loans from the TILA ability-to-repay requirement and, as a result, such loans do not qualify as QMs. As a result, if these loans were to be exempted from the CRR Rule, they would need to have a separate exemption, which is provided in the CRR Rule. The Agencies justified this exemption by citing the "strong underwriting procedures to maximize affordability and borrower success in keeping their homes" and noted that the exemption "serve[s] the public interest because these entities have stated public mission purposes to make safe, sustainable loans available primarily to [low-to moderate-income] communities."[17]

In the years since adoption of the CRR Rule, only a few CDFIs have used this exemption.[18] While HFAs have not used this exemption, staff discussions with market

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[16] *See, e.g.,* "On the Rise: Trading Desks Focusing on Non-QM Paper." *Inside MBS & ABS,* Inside Mortgage Finance Publications, 2019.30, 6.

[17] 79 FR 77602, 77694 (December 24, 2014).

[18] The Agencies identified seven securitizations that relied upon this exemption since 2019; these securitizations funded approximately $610 million in community-focused residential mortgages.

participants revealed that private securitization could become a more attractive option if a state HFA needed to issue bonds in excess of its tax-exempt allotment. Therefore, staff is not recommending a change at this time to the Community Mortgage Exemption.

Three-to-Four Unit Mortgage Exemption. Mortgages that are collateralized by three-to-four-unit properties are defined as "business purpose" loans rather than consumer credit transactions under TILA, and as such are not subject to the ability-to-repay requirement, and accordingly do not qualify as QMs. The Agencies recognized that securitization markets typically pool mortgages collateralizing one-to-four-unit mortgages with residential mortgage loans. The Agencies also provided an exemption for three-to-four-unit mortgages that otherwise would qualify as QMs to ensure that credit did not contract in this part of the market.

The number of mortgages collateralized by three-to-four-unit properties, and the percentage of such mortgages funded through private-label securitizations, is small.[19] The exemption also does not appear to be spurring any significant speculative activity in the securitization market and, at the same time, these properties are a source of affordable housing. Therefore, staff is recommending that the Agencies make no change to this exemption at this time.

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[19] Based on data reported under the Home Mortgage Disclosure Act (HMDA), there were about 35,000 such purchase originations in 2018 and 2019 combined, and of these, less than 2 percent appear to have been funded through private-label securitizations.

CONCUR: ___________________ _______________

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