Federal Deposit Insurance Corporation
3501 Fairfax Drive, Arlington, VA 22226-3500 Legal Division

February 10, 2012

TO: Executive Secretary

FROM: Kathleen M Russo, Supervisory Counsel
Legal Division

SUBJECT: Meeting with CRL Related to Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act

Please include this memorandum in the public file on the Notice of Proposed Rulemaking relating to Credit Risk Retention (RIN 3064-AD74), 76 Fed. Reg. 24090 (the "NPR").

On February 8, 2012, FDIC staff (Jonathan N. Miller, Luke H. Brown, Janet R. Gordon, Karyen Chu, Lariece M. Brown, David W. Riley, Ryan M. Goodstein, Stephen A. Quick, and Kathleen M. Russo) met with representatives of the Center for Responsible Lending (Ellen Harnick, Carolina Reid, and Barry Zigas), to receive comments on the NPR.

The discussion focused on the proposed definition of Qualified Residential Mortgage.

The attached was distributed at the meeting by CRL.

Balancing Risk and Access

Underwriting Standards for Qualified Residential Mortgages

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Presentation at the Federal Deposit Insurance Corporation, February 8, 2012

Introduction

- Policy debate centered on how to rebuild the housing finance system and avoid the mistakes of the recent past
- Key among these reforms are debates over how to define Qualified Mortgages and Qualified Residential Mortgages
  - Qualified Mortgages (QM)
    - Will define loans and underwriting criteria that will help to ensure that a borrower has a “reasonable ability to repay the obligation,” and will restrict the origination of loans with the riskiest features – such as no documentation of income, and loans with interest-only or balloon payments
  - Qualified Residential Mortgages (QRM)
    - Will set underwriting guidelines for mortgages that will be exempted from requirements that a portion of credit risk –at least 5 percent– be retained by the securitizer
- Assumption is that lenders and investors will view QM and QRM loans as safer products, and will originate loans that fit into both definitions

Introduction

- Concern that QRM will set up a new “dual mortgage market,” in which lower-wealth (including lower-income borrowers and borrowers of color) will bear the costs of non-QRM mortgages
  - Even if those costs are on the lower end of estimates, over the course of a loan, even a difference of 1-2 percentage points can add up to a significant difference in interest payments, with attendant implications for asset building
- Research literature suggests that down-payment constraints are significant factor that affect entry and timing of homeownership (Gyorko, Linneman and Wachter 1999, Bostic, Calem and Wachter 2005)
  - These barriers are more pronounced for lower-income and minority households, and lower rates of intergenerational wealth transfers can further restrict access to homeownership (Oliver and Shapiro 2006)
- There are also significant differences in FICO scores by race/ethnicity (Federal Reserve 2007) that may influence access to QRM mortgages

Research Questions

- What would be the effect of QM product restrictions on the overall default rate for first lien, owner-occupied mortgages?
- What are the tradeoffs of imposing additional QRM underwriting restrictions (e.g. LTV, FICO, and front-end DTI) on top of QM mortgages?
  - Benefits: prevent additional defaults
  - Costs: potentially exclude a large percentage of creditworthy borrowers from the QRM market
- What would be the impact on access of stricter QRM underwriting restrictions on low-income borrowers and borrowers of color?

Analytical Approach

All Loans

Prime, Subprime, AltA, FHA

What happens when you impose proposed QM standards on the universe of all loans?

QM Loans

Full documentation, no interest only, no balloon, no negative amortization, no prepayment penalties, no adjustable interest rates with fixed terms under 5 years and no terms over 30 years

FHA loans are also excluded

QRM Loans

QM + Proposed QRM Underwriting Restrictions

When you impose QRM underwriting restrictions on top of QM, what percent of defaults are prevented, and what percent of loans are excluded?

What number of performing loans are excluded?

Who (race/ethnicity and income) would be most affected?

Data

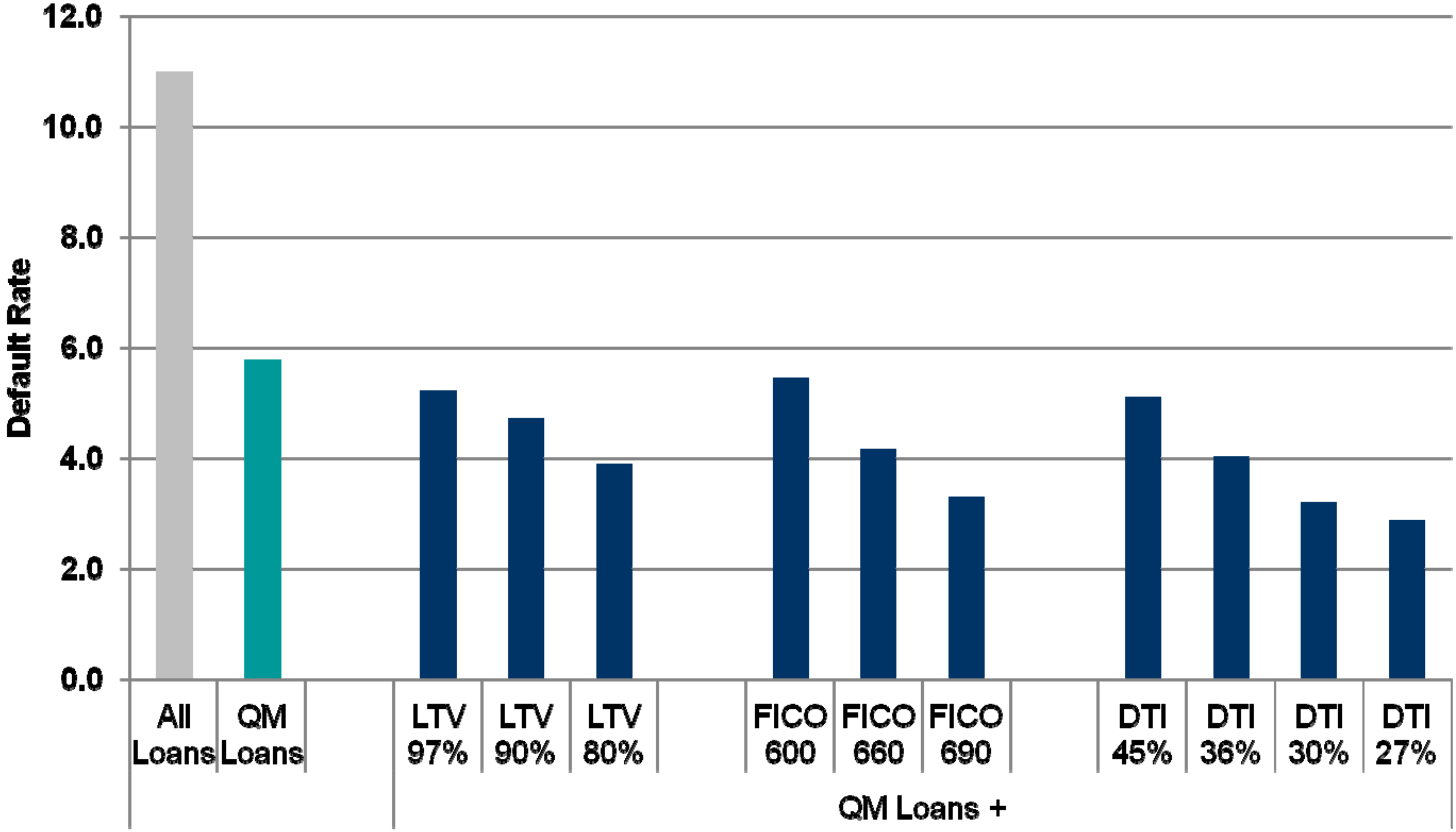
- LPS, BlackBox and HMDA
  - Unique dataset that allows us to analyze performance for a broad segment of the mortgage market, comprising prime, subprime, Alt-A and FHA loans
  - 2000 – 2008 originations
    - Race analysis is limited to home purchase loans originated between 2004 and 2008, uses probabilistic matching technique
  - Analysis of QRM underwriting thresholds is based on loans with populated CLTV information
- Default Rate
  - Loans that are 90 days delinquent, in foreclosure, or foreclosed upon as of February 2011

QM Product Term Restrictions Critical

Loan Type	Number of Loans in Sample[1] (2000-2008 Originations)	Default Rate[2]
All Loans	19,467,990	11.0%
Loans Meeting QM Product Term Limits[3]	10,871,569	5.8%
Prime Conventional	15,114,926	7.7%
Federal Housing Administration, excluding SFDPA[4]	1,631,318	9.7%
Alt - A	1,313,661	22.3%
Subprime Conventional	1,408,085	32.3%

1. Loans do not add up to total loans in sample due to missing data as well as overlap between the QM Product loans and other market segments.
2. Percentage of Loans 90+ Days Delinquent, in the Foreclosure Process, or Foreclosed Upon by February 2011.
3. Loans meeting QM product features are those that have full documentation, are not interest-only or negative amortizing loans, do not include a balloon payment, do not have adjustable interest rates with fixed terms under five years, do not have a maturity over 30 years, and do not include a prepayment penalty. We exclude FHA loans from the QM product loan category because statute exempts them.
4. Seller-Financed Downpayment Assistance Program.

More Restrictive Underwriting Criteria DO Result in Lower Default Rates



But, They Also Close Off Access to Higher Percentage of Borrowers

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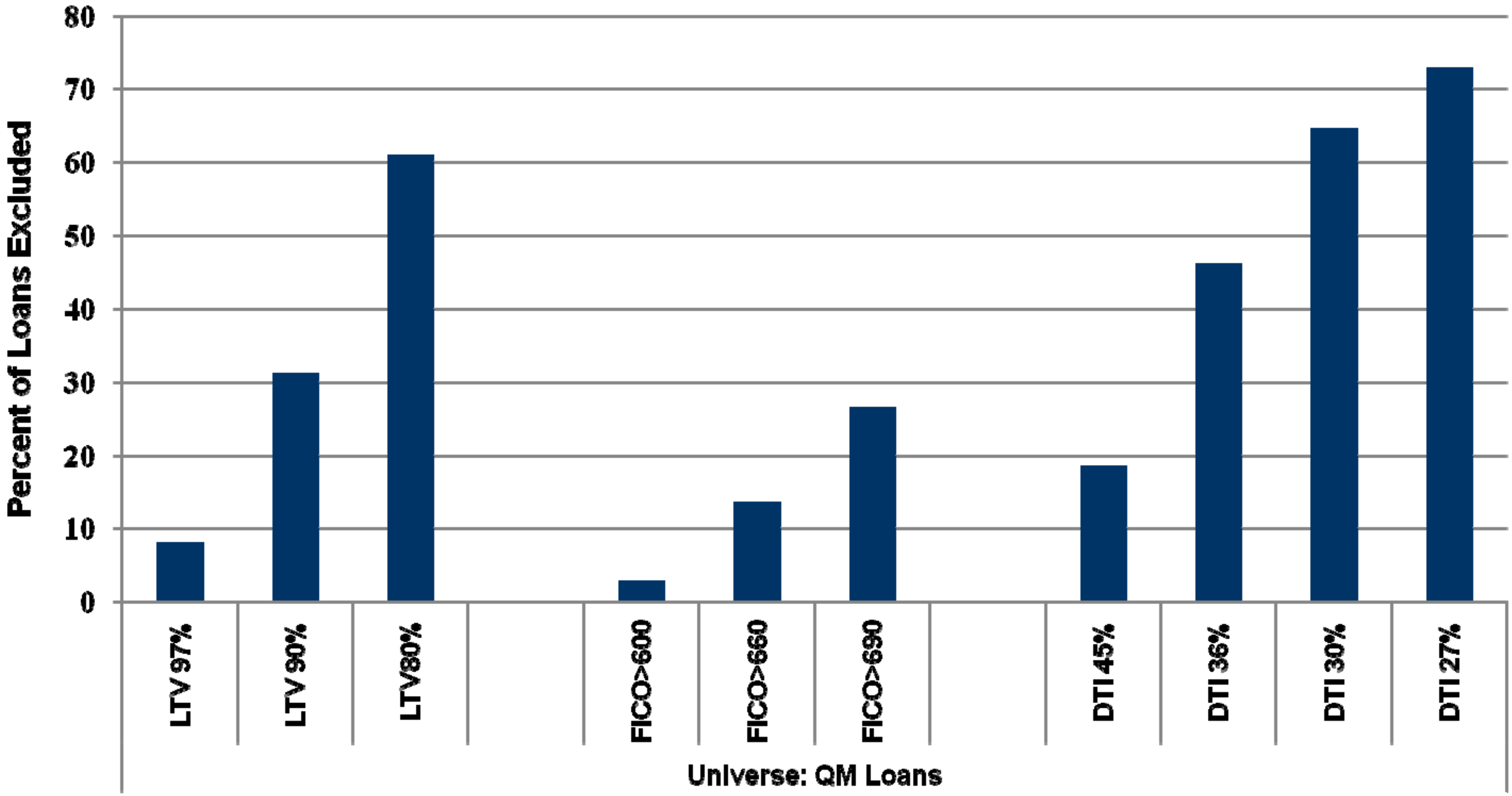
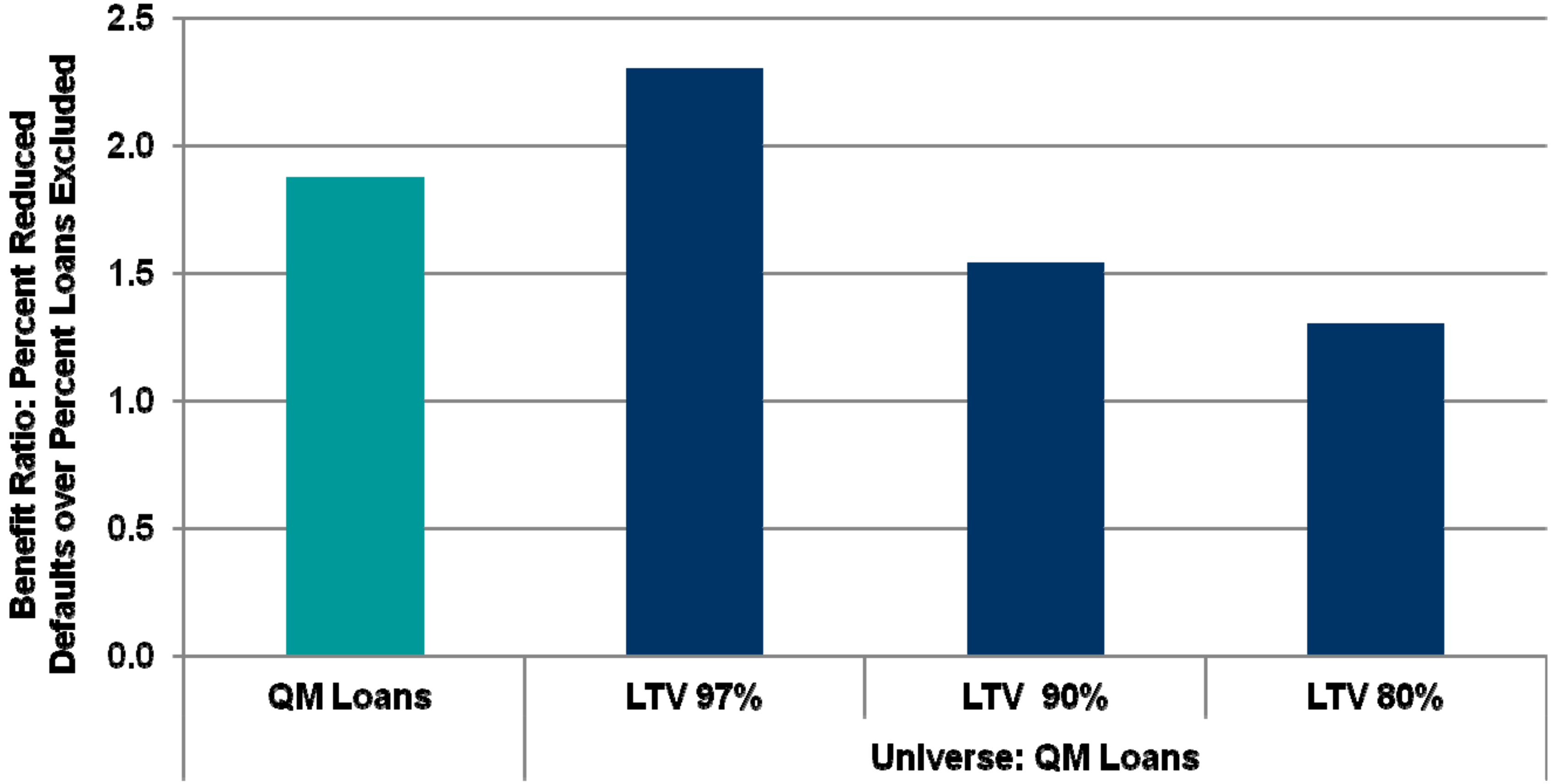


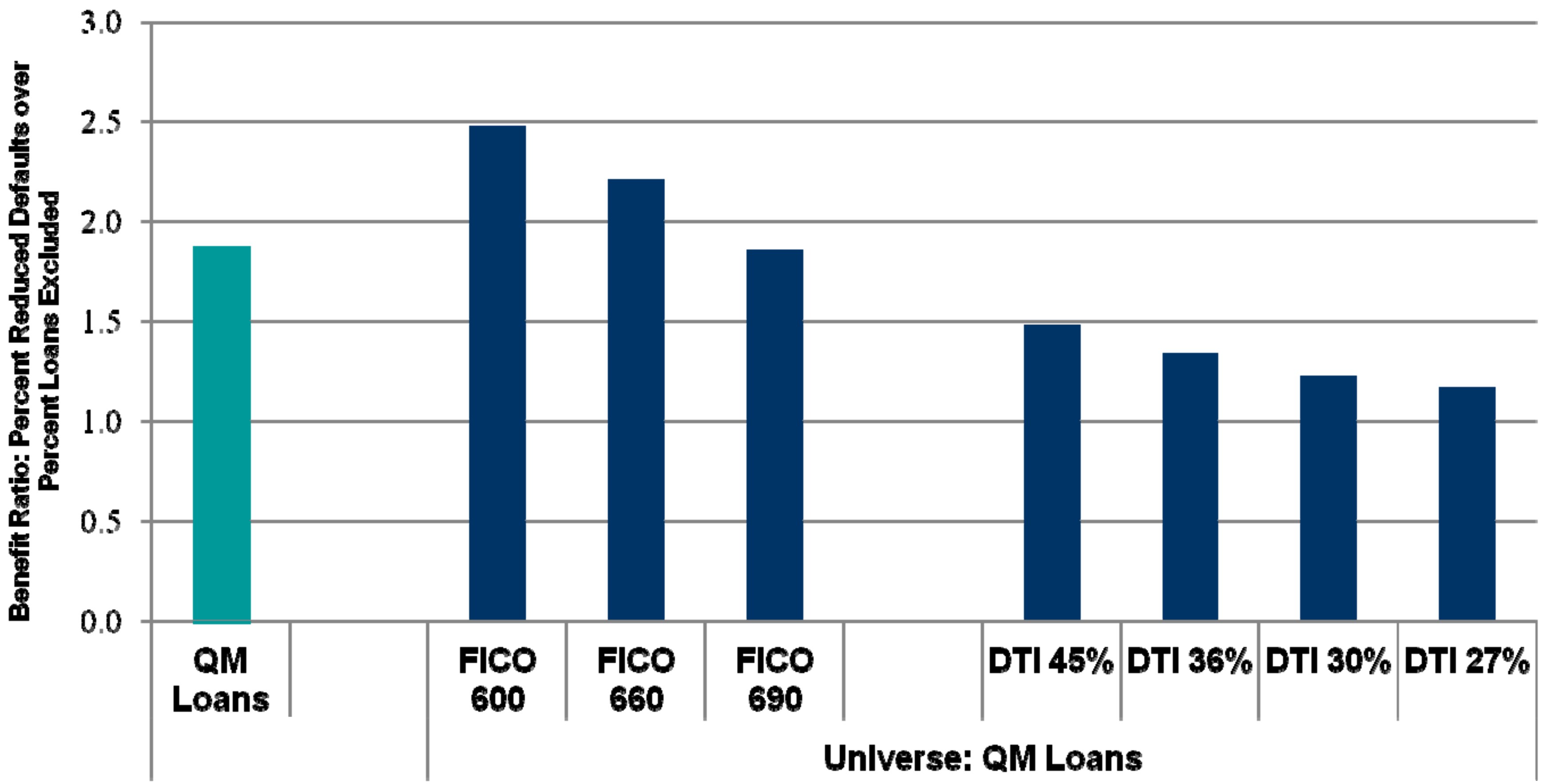
More Restrictive Thresholds are Less Effective When Access to Credit Taken into Account

Higher Downpayment Thresholds Prevent a Smaller Share of Foreclosures in Relation to the Borrowers they Exclude



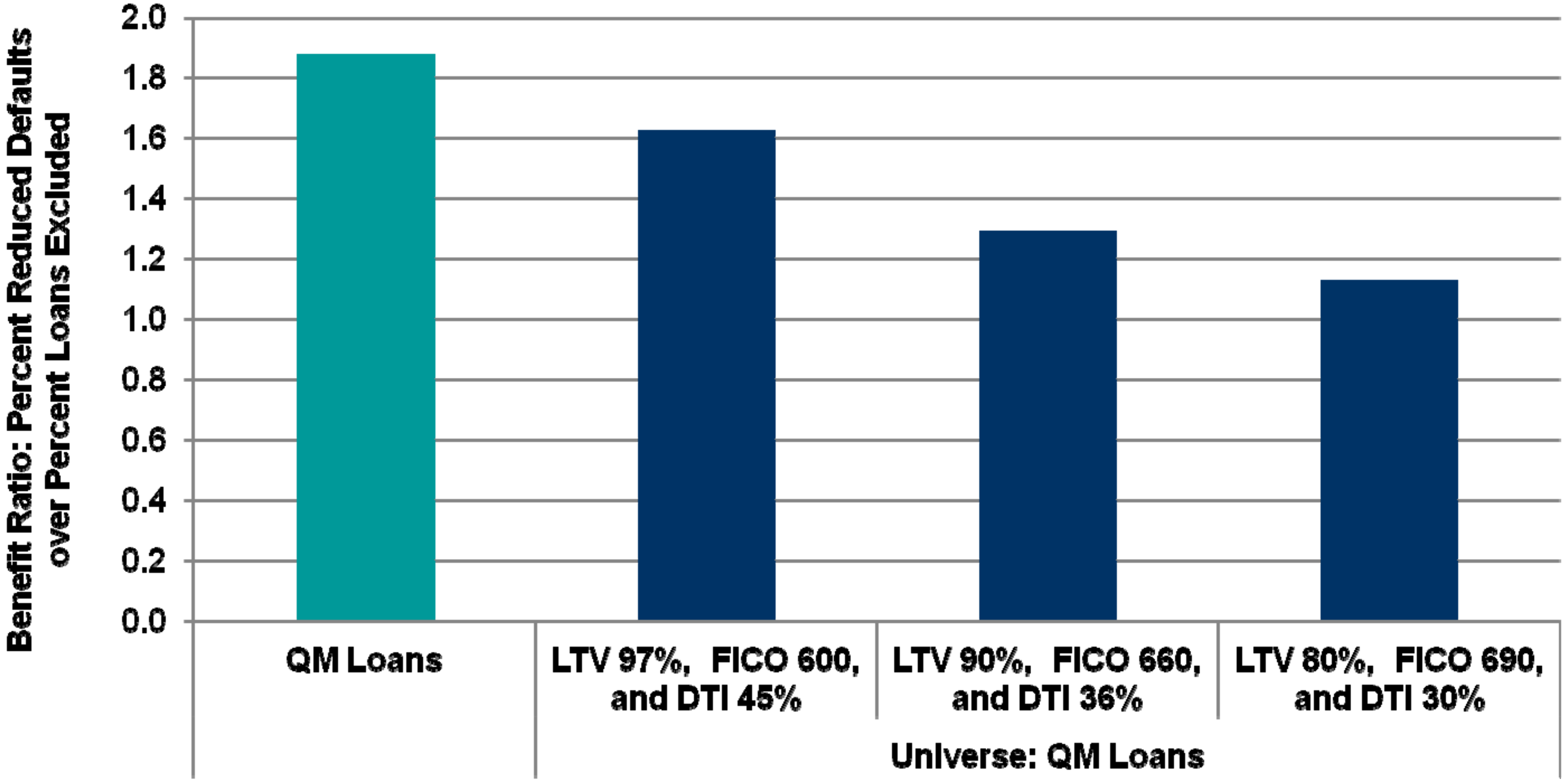
More Restrictive Thresholds are Less Effective When Access to Credit Taken into Account

More Restrictive FICO and DTI Thresholds Result in Lower Benefit Ratio



More Restrictive Thresholds are Less Effective When Access to Credit Taken into Account

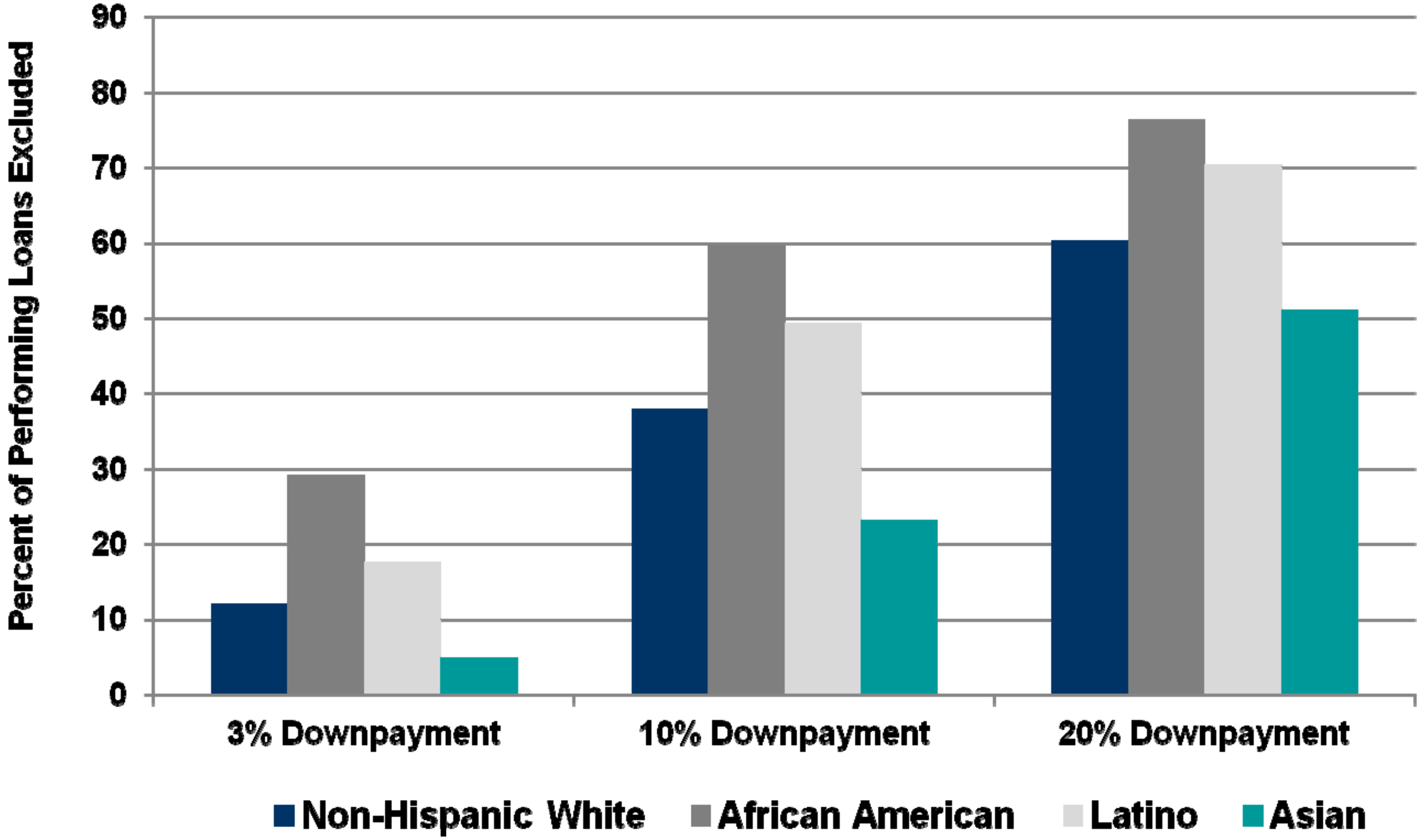
When Underwriting Thresholds are Combined, Even Least Restrictive is Less Efficient than QM on Its Own



Achieving Lower Default Rate Requires Excluding Large Share of Performing Loans from QRM

Alternate Underwriting Criteria	Exclusion Ratio (Number of QM Performing Loans Excluded per Prevented Default)
Universe: QM Loans	
LTV 97%	6:1
LTV 90%	9:1
LTV 80%	10:1
FICO < 600	5:1
FICO < 660	6:1
FICO < 690	7:1
DTI 45%	9:1
DTI 36%	10:1
DTI 30%	11:1
DTI 27%	12:1
LTV 97%, FICO 600, and DTI 45%	8:1
LTV 90%, FICO 660, and DTI 36%	10:1
LTV 80%, FICO 690, and DTI 30%	12:1

More Restrictive Thresholds Will Have Disproportionate Impact on Communities of Color



More Restrictive Thresholds Will Have Disproportionate Effect on Communities of Color

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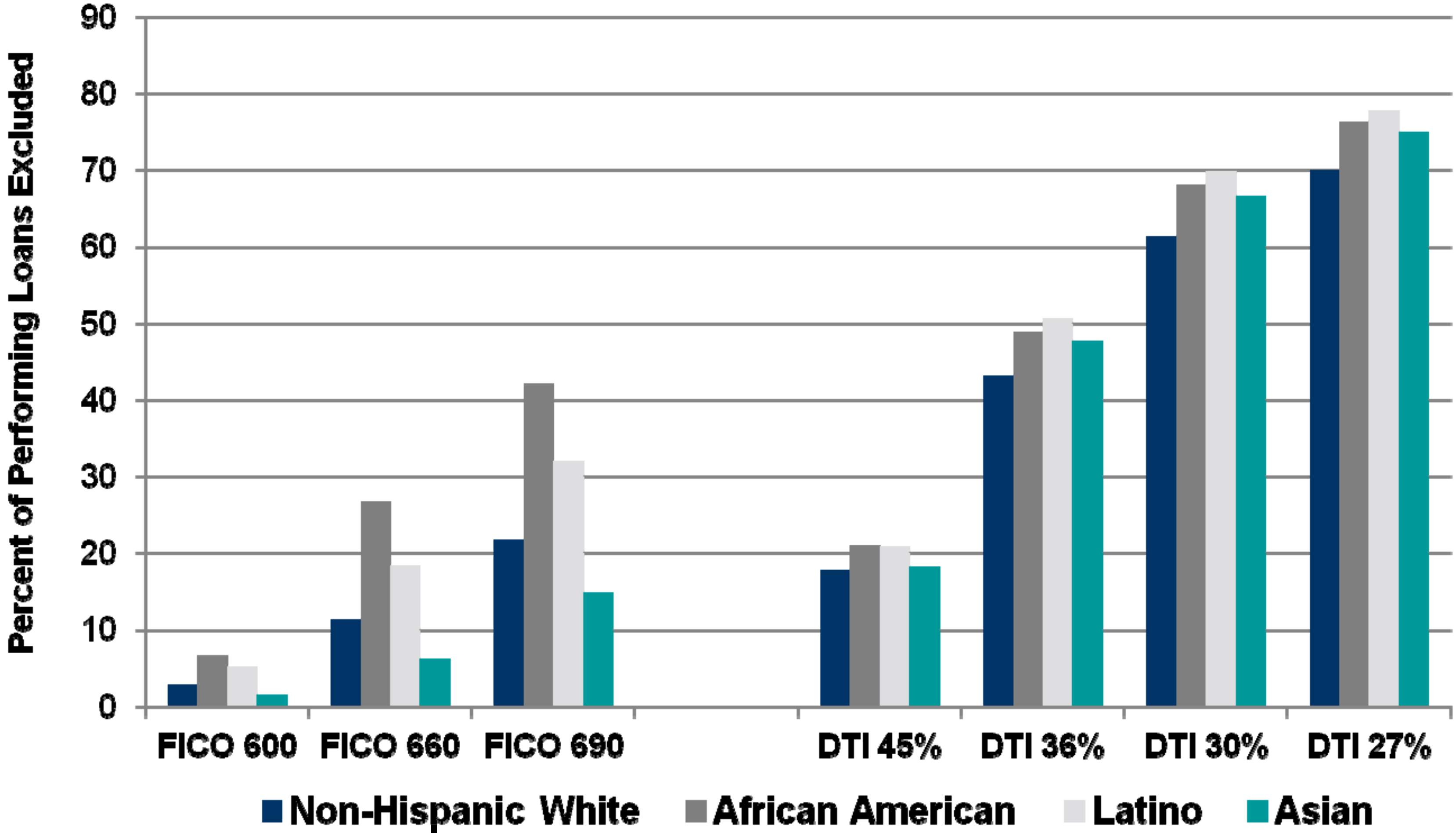
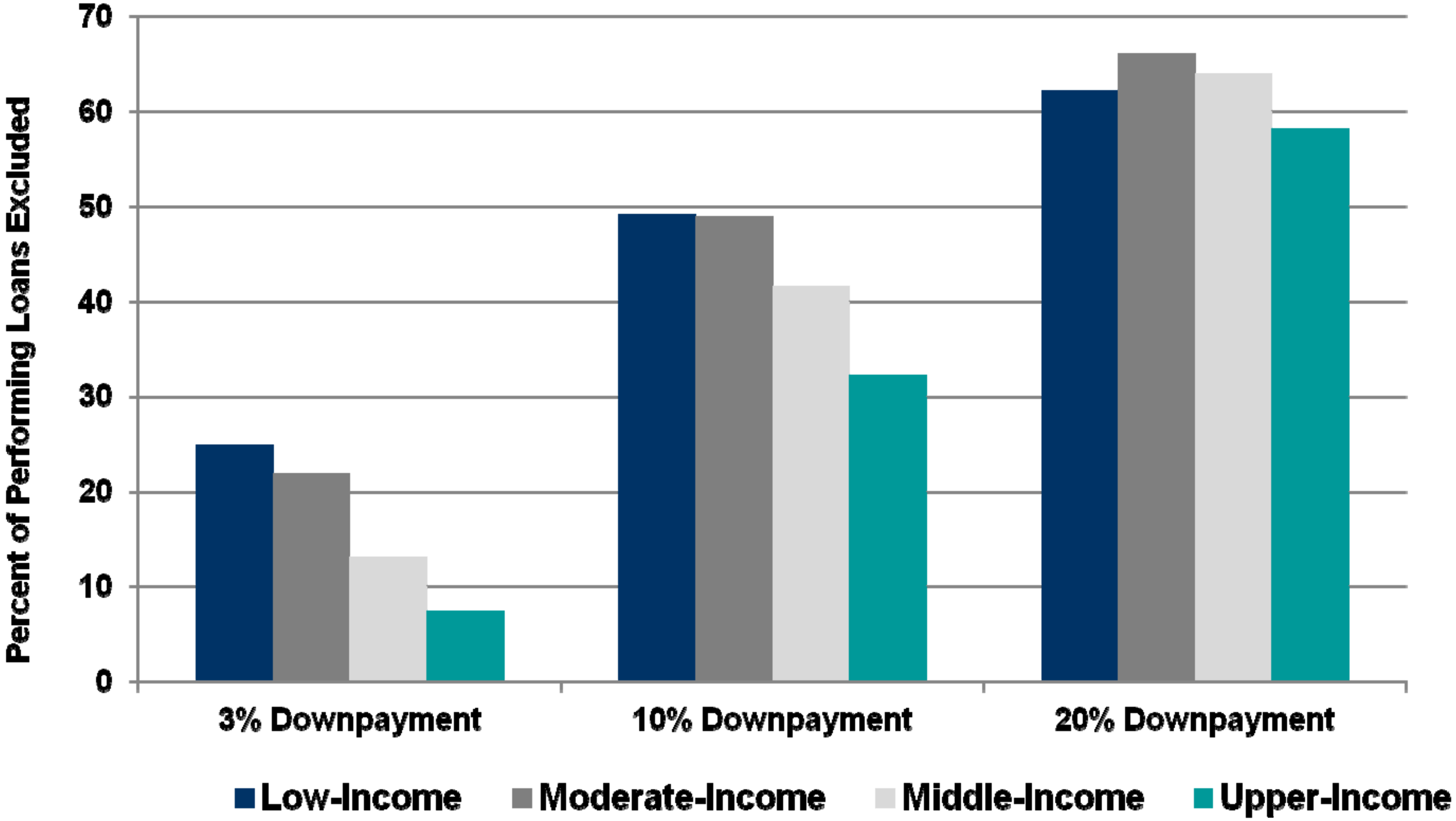


Low- and Moderate-Income Households Also Affected by Large Down-payment Requirements



Conclusions

- QM loan product restrictions **on their own** would do enough to curtail the risky lending that occurred during the subprime boom and bring foreclosure rates down to below prime conventional levels
- Imposing additional QRM underwriting requirements reduces the foreclosure rate, but also closes off access for a greater share of borrowers
  - Stricter requirements (e.g., down-payment requirements of 20% or FICO floor of 690) have smaller benefits in terms of reducing foreclosures when weighed against who is excluded
  - When underwriting thresholds are combined, even least restrictive (3% down-payment, FICO 600, and DTI 45%) is less effective than QM guidelines
- Stricter down-payment, DTI, and FICO requirements will disproportionately exclude low-income borrowers and borrowers of color
  - Policymakers should avoid creating a new “dual mortgage market”