



# *FedFin Client Report*

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Tuesday, October 21, 2014

## **Hoenig Concedes: QRM=QM**

Client Report: **ABS35**

### **Executive Summary**

After more than four years of debate, a final risk-retention rule was approved this morning at the open FDIC meeting analyzed in this report. Several other agencies also took it up, with the FRB set to do so tomorrow. The most significant dispute holding up action was the definition of a qualified residential mortgage (QRM) eligible for exemption from risk retention. Consistent with the 2013 proposal (see FSM Report **ABS32**), the final rule equilibrates the QRM and QM. FDIC Vice Chairman Hoenig had strongly objected to this in the revised NPR, but he conceded due to the need to advance secondary-market certainty and tough provisions related to collateralized loan obligations. Director Norton nonetheless stood firm and strongly opposed the QRM=QM standards, arguing not only that it will allow mortgages with loan-to-value ratios as high as 97 percent due to the GSE exemption, but also exposes the rule to legal challenge because so much authority is delegated to the CFPB. A four-year review process is included in the rule (up from the two years CFPB Director Cordray apparently believed it contained based on an earlier SEC draft). This did not satisfy Mr. Norton, but FDIC legal counsel assured the board that the rule is not subject to successful challenge.

Clients are reminded that risk retention for insured depositories depends not only on this rule, but also on the FDIC's determination as to which ABS are granted a safe harbor for its claims to collateral in the event of a receivership (see FSM Report **DEPOSITINSURANCE84**). Objections from Mr. Hoenig and Mr. Norton to the final rule will lead to strong pressure on the FDIC board to end the "auto-conformance" included in the current rule. However, it will take a decision by Chairman Gruenberg to instruct staff action to this effect and schedule a vote on it. Thus, we expect the FDIC's auto-conformance to last and its own standards also to equalize the QRM and QM.

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## Analysis

Key provisions in the final rule are:

- **QRM:** The QM standards now set the QRM. However, this definition will be reviewed four years after its effective date and every five years thereafter.
- **Risk-Retention Tranche:** The final rule requires fair-value calculation of the horizontal risk-retention position.
- **GSEs:** Loans sold to the GSEs retain exempt for as long as Fannie and Freddie remain in conservatorship.
- **CLOs:** Open-market CLO managers fall within the statutory definition of sponsor and thus remain required to hold risk-retention positions. A lead-arranger option remains.
- **Cash-Flow Restrictions:** These have been deleted from the final rule. However, fair-value and disclosure requirements remain.

As required by law, this rule is effective one year after its effective date for mortgages and two years thereafter for other asset classes.

In his comments, Chairman Gruenberg continued his practice of largely reiterating statute and rule. Vice Chairman Hoenig posed several questions, reiterating his support for a downpayment. He cited hard data that default risk rises in conjunction with loan-to-value ratios. Staff defended the current rule as a balancing act, with Mr. Hoenig conceding the point.

As noted, Director Norton opposed the rule because he continues to object to the QM criterion for QRMs. He argued that the QRM standards are improperly sub-delegated to the CFPB because the QRM is now inextricably linked to CFPB action over which the banking agencies have no control. He disputed the value of the lengthy review process as a way to side-step the sub-delegation question. He also argued that, because GSE mortgages are similarly exempted, loans with LTVs as high as 97 percent would be QRMs. Staff indicated that the GSE 97 percent loans were not discussed during the rulemaking process.

Chairman Gruenberg then asked FDIC counsel to opine on the sub-delegation question, receiving assurances that the rule is proper and appropriate under the law with regard to sub-delegation. This is based on the view that Congress gave the agencies specific direction to permit linkage between the

QRM and QM. Mr. Norton strongly questioned this opinion.

Comptroller Curry emphasized the importance of the QRM-review process and pressed for final action to enhance asset securitization. CFPB Director Corday withdrew objections raised when the proposal was released in 2013 (see Client Report **ABS31**), and now agreed that the QM and QRM can be equated to ensure a sound secondary market. He justified this change on grounds that mortgage credit is now unduly constrained. He also disagreed with Mr. Norton's legal reasoning on sub-delegation.