GSE Activity Report

Tuesday, August 25, 2020

Adding Seasoning to U.S. Mortgage Finance

Summary

The CFPB's proposal to allow QM treatment for certain seasoned mortgages will rewrite a decade's worth of securitized lending if macroeconomic and interest-rate conditions turn favorable. Once the QM coast is clear for portfolio loans, we expect large banks not only to make more of them both for their portfolios and eventual securitization, but also to renew experimentation with covered bonds. If portfolios grow, the GSEs' footprint will shrink – perhaps a lot, adverse selection will take on renewed importance in new bond and PLS markets, nonbanks will need a new gig, and MIs may finally crack bank portfolios.

Impact

A forthcoming FedFin in-depth report will go into detail on the provisions in the rule on which we base our strategic conclusions. In very short, this extra-long NPR provides that all lenders may consider 30-year, fixed-rate, first lien mortgages as QMs if they perform reasonably well during a 36-month seasoning period and otherwise conform to QM criteria with the notable exceptions not only of the DTI ceilings removed in the broader QM proposal, but also to the pricing criteria with which that proposal replaces them. Only hinted at in the NPR, it is clear to us not only that this NPR comes courtesy of large-bank lenders, but also of Administration officials looking to develop both portfolio and private-securitization options to Fannie and Freddie. If finalized largely as proposed, the newly-seasoned QM would:

- allow large banks to renew portfolio lending for borrowers who don't meet the exacting standards for jumbo-only products that governed this sector prior to the pandemic. Once the QM patch is ripped off, these newly-QM portfolio loans will have an edge over GSE-bound originations due to more generous DTI and pricing standards, allowing banks a new pricing advantage over the GSEs for these segments and opening up new secondary-market channels. As we have noted, the revised big-bank capital framework favors mortgage lending, especially at banks above the statutory $10 billion portfolio-lending QM exception that are not GSIBs. Given that the QM=QRM, seasoned QM loans are eligible for securitization without risk retention, affording an array of options starting with rights to hold

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interests in loans as the 36-month period ends as long as these are not commitments to sell and going on through all sorts of structuring to simple P&I issuances of mortgages;

- give MIs renewed hope of doing business on bank portfolio loans. Because seasoned loans are as noted not covered by any DTI threshold, banks might wish to walk on the wild side but also hedge risk even if these loans fall below the 80% LTV threshold. However, capital standards favoring MI are offset by continued CCAR ignominy under the stress capital buffer, creating cross-cutting challenges that will depend at least as much on price and terms as regulatory policy. Bank-sponsored CRT along lines attempted in 2019 by JPMorgan are also likely to resurface;
- lead to new partnerships between fintech-oriented nonbanks and lenders with capacity for loans given QM status only if held in portfolio;
- create considerable covered-bond opportunity. This has long been blocked because the FDIC's safe harbor is available only for QRMs which are of course QMs (see above). As we noted, there is a potentially very deep covered-bond market in the U.S. not tapped since 2006 due in recent years to GSE-pricing advantages. As noted, these would be fewer than ever before even if the GSEs continue in conservatorship and possibly even if the QM patch stays stuck. Three-year maturity covered bonds with a securitization take-out would be an interesting and possibly still more appealing variation on the long-established EU covered-bond construct; and
- GSE opportunities to credit enhance seasoned loans on portfolio prior to securitization and/or covered bonds. Whether this FHFA would countenance new activities is uncertain, but the next might be more amenable.

Outlook

Although proposed in part to spur mortgage availability during the pandemic, the QM change would actually not take effect until the broader rewrite is in place. The CFPB presumably adopts this approach because it is unwilling to allow seasoned-loan QM treatment under current rules for all the credit availability to follow because the DTI threshold would still apply and thus most loans would still go to Fannie, Freddie, and FHA. However, the NPR is replete with analyses laying out why seasoned loans are low risk no matter the DTI as long as income is verified. A case could thus be made – and we expect some commenters vociferously to do so – that seasoned-loan QM treatment should be quickly adopted. The very short, thirty-day deadline suggests that the Bureau may even contemplate such a step.

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