Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

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Although it seems technical, the question of what's a qualified mortgage (QM) defines which mortgages make up most of the U.S. market. This, though, is well known after years of QM squabbles. What many have forgotten is an even bigger question: what's a qualified residential mortgage (QRM). This term defines which mortgages can be securitized without forcing the originator to hold "skin in the game" – i.e., a portion of the loan on its portfolio. Given the transformation of U.S. mortgage finance into a business dominated by nonbanks without balance sheets, a problematic QRM would quash a whole lot of mortgage finance no matter the QM.

The banking agencies, SEC, FHFA, and HUD finalized the QRM in 2014 after two proposals and a whole lot of controversy. The problem crafting the QRM was the wide divide between MBS investors – who wanted tough credit-risk retention to ensure incentive alignment – and lenders who wanted none of this. Policy-makers were split, but the balance ultimately came down in favor of the current QRM because of concerns so soon after the great financial crisis that housing finance couldn't recover without a free pass to the secondary market. Private-label securitizers pushed for equal treatment with the GSEs if private credit enhancements or other capital stood ahead of the investor in a QRM, but the reputation of private mortgage insurance (MI) was badly sullied by the crisis and there was little faith in PLS or their ratings after the subprime-MBS debacle. As a result, the final rule said that QRMs were any loan that was also a QM and, given that the QM then applied to any loan sold to the GSEs and FHA, the mortgage market quickly turned into QMs sold almost exclusively through taxpayer-backed channels.

However, this was a roughly-hewn compromise many hoped would be redesigned as the GSEs exited conservatorship. As a result, regulators agreed to study the QRM and recraft it in five years (the SEC wanted this in two to help investors out, but so much for that). This five-year review period ended in December of 2019 following an inter-agency announcement of what was under consideration. The review period was pushed back last year and now ends on Sunday, June 20. Given all that's changed in mortgage finance since 2014, the QRM could well be set for a rewrite. Although the CFPB has stayed its hand on the new QM, the differences between it and the old QM combined with the changing role of the GSEs challenge the credibility of continuing to equilibrate the QM and QRM without careful review.

Many of the old fights over the QRM will resurface in the new rewrite, most importantly the extent to which any loan sold to the GSEs gets to be considered a QRM now that the QM patch is about to be lifted and FHFA wants the conservatorship gone as fast as possible in favor of the PLS still doomed by the current QRM. MIs might get another bite at the apple as eligible forms of credit risk retention, creating a new form of charter coverage to supplement or even supplant the credit-enhancement mandated for GSE originations. The FDIC's safe-harbor for bank securitizations is linked to the QRM, making a new QRM also critical to revived big-bank hopes for covered bonds.

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And then there are nonbank mortgage originators. As I said, credit-risk retention for them is essentially impossible. Would bank regulators now use it to return mortgage finance to those under their thumb? We shall see.