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## "Skin in the Game":

# The Qualified Residential Mortgage Rule

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One of the most controversial, far-reaching, and profound mortgage-related provisions of the Dodd-Frank Act is the "skin in the game" requirements of section 941. Under these provisions, securitizers of asset-backed securities (ABS) must retain at least 5% of the credit risk unless the mortgage conforms to the starkly conservative "qualified residential mortgage" (QRM) standards. According to Congress, when securitizers retain a material amount of risk, they have "skin in the game," aligning their economic interests with those of investors in ABS.

The Federal Reserve Board, along with other federal regulators, published the proposed QRM rule on March 29, 2011, seeking input on 174 individual QRM-related questions. On June 6, the Board announced that the comment period had been extended to August 1, 2011.

### What is a Qualified Residential Mortgage?

If an originator makes a QRM, the originator is not required to retain a portion of the risk on that loan when the loan is securitized. Under the proposal, a QRM must be closed-end first-lien mortgage loan with a term not exceeding 30 years. While ARMs may be QRMs, the terms of the ARM must provide that any rate increase must not exceed 2% any year and 6% over the life of the loan.

In terms of underwriting standards to qualify as a QRM, the proposal calls for maximum front-end and back-end borrower DTI ratios of 28% and 36%, respectively; a maximum LTV ratio of 80% for purchase transactions (75% for refis and 70% for cash-out refis); 20% down payment for purchase transactions; and no 60-day delinquencies in the borrower's credit history in the past 24 months. Further, for QRMs, the "points and fees"—a broadly defined term that includes most up-front fees, fees paid to affiliates, and bona fide discount points—must not exceed 3% of the loan amount.

### Who has to retain the risk?

The securitization "sponsor" (the party that packages the ABS) is responsible under the proposed rule for the retaining the risk. But the sponsor may allocate a proportional share of the risk retention obligation to the "originator" (the original creditor, but not any intermediate purchaser or transferee) of the securitized assets, subject to certain conditions. While the agreement to transfer a portion of the risk to the originator would be voluntary on the originator's part, it is anticipated that sponsors may require risk retention as a condition of securitization.

For any ABS in which the sponsor pushes risk retention down to the originator, an originator may be required to take on any amount of risk up to its proportional share of the ABS pool. But only originators with at least 20% of the loans in the securitization may be asked to take on any retained risk. An originator may take on the risk by paying up front for its share, either in cash or a discount on the selling price of the loans. When risk is retained, the holder is precluded from hedging the risk.

### What forms can the risk retention take?

The proposed rule seeks to offer flexibility in retaining risk by providing several options that the sponsor and securitizer may choose based on the asset involved, the market, and investor expectations.

The forms of acceptable risk retention include (i) a 5% "vertical" slice of the ABS interests, under which the sponsor retains a proportional share of each class of interests; (ii) a 5% "horizontal first-loss" position, under which the sponsor bears losses on the assets before any other classes of interests; (iii) an "L-shaped" interest, under which the sponsor retains half the risk in a vertical slice and half in a horizontal first-loss position; (iv) a "seller's interest" in securitizations under which the holder participates in revenues and losses on the same basis as the investors; or (v) a "representative" sample, under which the sponsor retains a 5% sample of assets.

### What about Fannie and Freddie loans? FHA loans?

For the time being, there is a gaping exception under the proposed QRM rule: for loans securitized through Fannie Mae and Freddie Mac, the government's guarantee satisfies the risk retention requirements. Thus, as long as Fannie and Freddie are under conservatorship, no originator will be required to retain risk for loans securitized through these enterprises. But, especially in pricier markets and if Fannie and Freddie loan limits are drawn down, more loans may become subject to the risk retention provisions.

With respect to FHA, USDA, and VA loans, loans that are fully guaranteed or insured by the U.S. government, or an agency of the government, are exempt from the risk retention requirements.