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MORTGAGE REFORM

Potential Impacts of Provisions in the Dodd-Frank Act on Homebuyers and the Mortgage Market

GAO-11-656

Highlights

Highlights of GAO-11-656, a report to congressional committees

MORTGAGE REFORM

Potential Impacts of Provisions in the Dodd-Frank Act on Homebuyers and the Mortgage Market

Why GAO Did This Study

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) is intended, among other things, to reform residential mortgage lending and securitization practices that contributed to the recent financial crisis. The act provides some liability protection for lenders originating mortgages that meet nine specified criteria, as applicable, associated with a borrower's ability to repay ("qualified mortgages"). The act also requires securitizers of mortgages not meeting separate criteria associated with lower default risk to retain at least 5 percent of the credit risk, though federal rulemaking agencies may vary this amount. The act directed GAO to assess the effect of mortgage-related provisions on the availability and affordability of mortgage credit and to issue a report by July 2011, but federal agencies are still developing implementing regulations. This report discusses the potential impact of the act's (1) qualified mortgage criteria, (2) credit risk retention requirement, and (3) provisions concerning homeownership counseling and regulation of high-cost loans.

To do this work, GAO analyzed a proprietary database of residential mortgages, reviewed relevant housing and mortgage market research, and interviewed key mortgage industry stakeholders.

GAO provided a draft of this report to eight agencies. In a letter, the National Credit Union Administration said, as noted in the report, that the act's impact would depend on regulatory decisions that had yet to be made. Six other agencies provided technical comments that have been incorporated as appropriate.

View GAO-11-656 or key components.
For more information, contact William B. Shear at (202) 512-8678 or shearw@gao.gov.

What GAO Found

GAO examined five of the nine qualified mortgage criteria specified in the Dodd-Frank Act for which sufficient data were available and generally found that, for each year from 2001 through 2010, most mortgages would likely have met the individual criteria. The five criteria address payment of loan principal, length of the mortgage term, scheduled lump-sum payments, documentation of borrower resources, and borrower debt burden. The extent to which mortgages met the individual criteria varied by year of origination, reflecting changes in the mortgage market over the 10-year period. However, the impact of the full set of qualified mortgage criteria is uncertain, partly because data limitations make analysis of the other four criteria difficult and partly because federal agencies could establish different criteria as they develop final regulations. Consumer and industry groups indicated that the criteria specified in the act would likely encourage sound underwriting but could also restrict the availability of and raise the cost of mortgage credit for some homebuyers. Provisions in the act and proposed regulations attempt to address some of these issues, in part by providing exemptions for certain loan products in certain locales, such as rural areas. The public comment period for these proposed regulations ends on July 22, 2011.

Mortgage industry stakeholders GAO spoke with indicated that the implications of a risk retention requirement would depend on a variety of regulatory decisions and potential changes in the mortgage market. Rulemaking agencies are accepting public comments on proposed risk retention regulations through August 1, 2011. Key decisions that have yet to be made concern the characteristics of mortgages that would be exempt from risk retention, the forms of risk retention that would be allowed, the percentage that securitizers would be required to hold, and risk-sharing arrangements between lenders and securitizers. These factors could affect the availability and cost of mortgage credit and the viability of a private mortgage securitization market. Additionally, risk retention could complement other securitization and mortgage reforms, such as those that promote greater transparency and enforcement of loan underwriting standards.

Other provisions in the Dodd-Frank Act concerning homeownership counseling and regulation of high-cost loans could enhance consumer protections and improve mortgage outcomes for some borrowers, but their specific impacts are difficult to assess at this time. The act authorized a new Office of Housing Counseling within the Department of Housing and Urban Development, but the office is still in the planning stage. Findings from the limited research on housing counseling for mortgage borrowers are mixed, with some studies suggesting that some types of counseling can improve mortgage outcomes and others finding no effect. The act also expands the definition of "high-cost loans," which have disclosures and restrictions designed to protect consumers. Although lenders have generally avoided making these loans, additional information on mortgage costs would be needed to assess the extent to which the new definition would affect mortgages that may be made in the future.

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Abbreviations

APR	annual percentage rate
ARM	adjustable-rate mortgage
CFPB	Bureau of Consumer Financial Protection or Consumer Financial Protection Bureau
Dodd-Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act
DTI	debt service-to-income
FAS	financial accounting statement
FDIC	Federal Deposit Insurance Corporation
Federal Reserve Board	Board of Governors of the Federal Reserve System
FHA	Federal Housing Administration
FHFA	Federal Housing Finance Agency
HMDA	Home Mortgage Disclosure Act
HOEPA	Home Ownership Equity Protection Act of 1994
HUD	Department of Housing and Urban Development
LTV	loan-to-value
NCUA	National Credit Union Administration
NFMC	National Foreclosure Mitigation Counseling
OCC	Office of the Comptroller of the Currency
OTS	Office of Thrift Supervision
QM	qualified mortgage
QRM	qualified residential mortgage
REIT	real estate investment trust
RMBS	residential mortgage-backed securities
SEC	Securities and Exchange Commission
SPE	special purpose entity
TILA	Truth in Lending Act

United States Government Accountability Office
Washington, DC 20548

July 19, 2011

The Honorable Tim Johnson
Chairman
The Honorable Richard C. Shelby
Ranking Member
Committee on Banking, Housing,
and Urban Affairs
United States Senate

The Honorable Spencer Bachus
Chairman
The Honorable Barney Frank
Ranking Member
Committee on Financial Services
House of Representatives

The number of homes in foreclosure and of homeowners in financial distress remains at historically high levels. In the first quarter of 2011, more than 3.5 million home mortgages were 90 or more days delinquent or in the foreclosure process, and estimates indicate that more than one in five mortgage borrowers owe more on their mortgages than their homes are worth. The continuing foreclosure crisis was fueled in part by the proliferation of mortgage products in the early to mid-2000s that have come to be associated with poorer loan performance. These products include mortgages with interest rates that increased sharply after a few years, did not require a down payment or full documentation of income, or allowed borrowers to defer principal and interest payments, increasing their indebtedness over time. Some mortgage brokers and originators had financial incentives to steer borrowers who qualified for potentially more sustainable options into such mortgages. After home prices began to stagnate or fall in 2005, defaults and foreclosures increased rapidly. Complicating matters during this period were securitization practices, which included bundling higher-risk mortgages into residential mortgage-backed securities (RMBS) that, in turn, were sometimes repackaged into more complex investment products.[1] As demand for RMBS grew, lenders

[1]Securitization allows lenders to sell loans from their portfolios, transferring credit risk to investors, and use the proceeds to make more loans.

and securitizers were increasingly compensated based on loan volume rather than loan quality, contributing to a decline in underwriting standards.

To help prevent a recurrence of such problems in the mortgage market, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) on July 21, 2010.[2] A key challenge in implementing the Dodd-Frank Act's provisions is balancing the goal of protecting borrowers from unsustainable mortgage products with the goal of maintaining broad access to mortgage credit. Among other things, the Dodd-Frank Act establishes minimum standards for mortgages, requiring that consumers have a "reasonable ability to repay" at the time a mortgage is made when the loan terms, applicable taxes, homeowner's insurance, and assessments are taken into account. This consumer protection provision creates due diligence standards for mortgage lenders. According to the Dodd-Frank Act, a lender is presumed to have satisfied the ability-to-repay requirement and receives some protection from liability when it originates a "qualified mortgage" (QM).[3] The Dodd-Frank Act specifies nine criteria that a loan must meet to be a QM:

(1) regular periodic payments do not result in an increase in the principal balance or result in a deferral of the repayment of principal;

(2) the loan term does not exceed 30 years;

(3) except for balloon loans under specified circumstances, the mortgage does not include balloon payments;[4]

[2]Pub. L. 111-203.

[3]We use the term "lender" to refer to what the Dodd-Frank Act calls a mortgage "originator" or "creditor." A lender can also meet the Dodd-Frank Act's ability-to-repay requirement by originating a mortgage that satisfies eight underwriting factors which emphasize consideration of borrower characteristics such as employment and current or expected income. We focus on the QM criteria, which emphasize mortgage features, because data available to us primarily contained information on mortgage characteristics.

[4]A balloon payment is a large lump-sum payment scheduled at the end of a series of smaller periodic payments. Section 1412 of the Dodd-Frank Act defines a balloon payment as a scheduled payment that is more than twice as large as the average of earlier scheduled payments.

(4) borrower income and financial resources are verified and documented;

(5) the loan complies with guidelines or regulations established by the Board of Governors of the Federal Reserve System (Federal Reserve Board) relating to ratios of total monthly debt to monthly income or alternative measures of ability to pay regular expenses after paying total monthly debt;

(6) a fixed-rate loan is underwritten based on a fully amortizing payment schedule that takes into account applicable taxes, insurance, and assessments;

(7) an adjustable-rate mortgage (ARM) is underwritten based on the maximum rate permitted during the first 5 years and on a fully amortizing payment schedule that takes into account applicable taxes, insurance, and assessments;

(8) total points and fees payable in connection with loan do not exceed 3 percent of the total loan amount;[5] and

(9) a reverse mortgage that meets QM standards as set by the Federal Reserve Board.[6]

The Dodd-Frank Act gave federal rulemaking agencies the flexibility to change these criteria.

The Dodd-Frank Act also requires mortgage securitizers to retain a financial exposure of no less than 5 percent of the credit risk of any securitized residential mortgage that does not meet a separate set of criteria (to be defined by regulators) that are associated with a lower risk of default.[7] Securitized mortgages that meet these criteria are exempt

[5]A point is a loan charge, usually paid at loan closing, expressed as a percentage of the loan amount (1 point is 1 percent of the loan balance).

[6]A reverse mortgage is a loan that converts the borrower's home equity into payments from a lender and typically does not require any repayments as long as the borrower continues to live in the home.

[7]The Dodd-Frank Act defines a securitizer as an issuer of an asset-backed security or a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer.

from this risk retention requirement and are referred to as “qualified residential mortgages” (QRM). The risk retention provision is designed to provide an economic incentive for securitizers of non-QRMs to ensure that lenders originate well-underwritten mortgages that protect investors from losses. Although the Dodd-Frank Act contains a uniform 5 percent requirement, it gives federal regulators the flexibility to specify a risk retention requirement for nonexempt mortgages that varies depending on the underwriting standards used.

Given the serious problems that continue in the mortgage market and congressional interest in protecting consumers and ensuring credit availability, we were required to assess the potential impact of the mortgage-related provisions of the Dodd-Frank Act and issue a report by July 21, 2011. Because regulations governing implementation of these provisions are still being developed, the criteria we assessed could change based on rulemakers’ review of comments from the public on the proposed rules. The public comment periods for proposed QM and QRM rules will end on July 22 and August 1, 2011, respectively. Partly for this reason, assessing the potential impact of the Dodd-Frank Act provisions is challenging at this time. This report (1) assesses the proportions of mortgages originated from 2001 through 2010 that would have met selected QM criteria specified in the Dodd-Frank Act and describes the views of mortgage industry stakeholders on the potential effects of the QM criteria on the mortgage market, (2) discusses relevant information and the views of mortgage industry stakeholders on the potential impact of a risk retention requirement on the mortgage market and the advantages and disadvantages of a uniform risk retention requirement, and (3) describes what research and the views of mortgage industry stakeholders suggest about the potential impact of provisions in the Dodd-Frank Act regarding homeownership counseling and changes to the Home Ownership Equity Protection Act (HOEPA).[8] For practical reasons, we examined these different parts of the Dodd-Frank Act separately. Although the purpose and scope of the QM and QRM provisions are somewhat different, they could be expected to work together by increasing lenders’ and securitizers’ exposure to the risks that are associated with mortgages whose features and terms put borrowers at higher risk of default and foreclosure.

[8]HOEPA, enacted in 1994, regulates and restricts the terms and characteristics of certain kinds of high-cost mortgages.

Because recovery from today's restricted credit conditions could expand the volume and types of mortgage products in the marketplace, we used historical data to illustrate the potential effects of selected QM criteria under different market conditions and lending environments. Specifically, we analyzed a proprietary database of loans from CoreLogic, Inc., to examine the proportions of loans originated from 2001 through 2010 that likely would have met selected QM criteria specified in the Dodd-Frank Act. This database contains information from major mortgage servicers and covers a broad cross-section of the mortgage market. For example, CoreLogic estimates that the database captures 60 to 65 percent of the mortgages purchased by Freddie Mac and Fannie Mae (the enterprises), respectively, approximately 50 percent of subprime mortgages, and about 90 percent of mortgages with government-insurance or guarantees (such as mortgages insured by the Federal Housing Administration (FHA)).[9] Nevertheless, because of limitations in the coverage and completeness of the data, our analysis may not be fully representative of the mortgage market as whole. We examined five of the nine QM criteria specified in the Dodd-Frank Act for which sufficient data, including data from the CoreLogic database, were available (see the first five criteria previously listed).[10] In general, for each year from 2001 through 2010, we identified the proportion of mortgage originations that would have met the individual criteria. We were not able to calculate relevant proportions for certain years and mortgage market segments due to data limitations. Primarily due to data limitations, we were also not able to assess the remaining four QM criteria (see the last four criteria listed previously).

We assessed the reliability of the CoreLogic data by interviewing CoreLogic representatives about the methods the firm used to collect and ensure the integrity of the information. We also reviewed supporting documentation about the database. In addition, we conducted

[9]The enterprises purchase mortgages that meet specified underwriting criteria from approved lenders. Most of the mortgages are made to prime borrowers with strong credit histories. The enterprises bundle the mortgages into securities and guarantee the timely payment of principal and interest to investors in the securities. On September 6, 2008, the enterprises were placed under federal conservatorship because of concern that their deteriorating financial condition and potential default on $5.4 trillion in outstanding financial obligations threatened the stability of financial markets.

[10]As presented in appendix II, we used data from the Census Bureau and information on state-level house price trends to examine the proportions of mortgages within different geographic groupings (based on demographic and housing market characteristics) that likely would have met four of these criteria.

reasonableness checks on the data to identify any missing, erroneous, or outlying figures. We concluded that the data elements we used were sufficiently reliable for our purposes. To obtain additional information and views on the potential effects of the QM criteria specified in the Dodd-Frank Act, we reviewed proposed rules for implementing the Dodd-Frank Act's QM provisions. We also reviewed relevant research literature and interviewed officials from organizations representing mortgage lenders, mortgage brokers, investors, securitizers, and consumer interests. Additionally, we interviewed officials from the Federal Reserve Board, Federal Deposit Insurance Corporation (FDIC), Federal Housing Finance Agency (FHFA), Department of Housing and Urban Development (HUD), National Credit Union Administration (NCUA), Office of the Comptroller of the Currency (OCC), and Office of Thrift Supervision (OTS).

To assess the potential impact of the Dodd-Frank Act's risk retention requirement on the mortgage market, we reviewed relevant statutory provisions and the rules that have been proposed to implement those provisions. We also reviewed available information on mortgage securitization practices prior to the financial crisis and factors that could affect the impact of the risk retention requirement, including potential changes to the roles of the enterprises and FHA. We interviewed key mortgage industry stakeholders—including those representing mortgage lenders, securitizers, investors, and consumers—to obtain their views on the potential impact of a risk retention requirement including how regulatory decisions regarding the form and coverage of the requirement could affect the availability and affordability of mortgage credit. We used the CoreLogic data to examine selected criteria—loan-to-value (LTV) ratio and debt service-to-income (DTI) ratio—that regulators are considering as part of the QRM rulemaking to describe the proportion of mortgages that may have met different LTV and DTI thresholds in 2006 (a period of relatively lax underwriting standards) and 2010 (a period of relatively stringent underwriting standards).[11] To assess the impact of the risk retention requirement on lenders, we reviewed relevant accounting standards and risk-based capital requirements that could interact with risk retention. We also interviewed industry stakeholders about the impact of a risk retention requirement on different types and sizes of mortgage lenders. To assess the advantages and disadvantages of a uniform 5

[11]The LTV ratio is the loan amount divided by the value of the home at mortgage origination. The DTI ratio represents the percentage of a borrower's income that goes toward all recurring debt payments, including mortgage payments.

percent risk retention requirement, we interviewed industry stakeholders about the development, implementation, and enforcement of both a uniform and a nonuniform requirement. Finally, we interviewed officials from the previously cited federal agencies and the Securities and Exchange Commission (SEC).

To describe the potential effects of the housing counseling and HOEPA provisions in the Dodd-Frank Act, we reviewed relevant statutory provisions and industry research. We identified and reviewed empirical research and published literature on the impact of prepurchase and foreclosure mitigation counseling on mortgage outcomes. We also interviewed HUD officials about their plans for creating the new housing counseling office required by the Dodd-Frank Act. We compared the new HOEPA requirements in the Dodd-Frank Act to previous statutory requirements and examined available research on the number of loans originated from 2004 through 2009 that were covered by HOEPA requirements. We also interviewed a wide range of mortgage and counseling industry stakeholders, including federal agencies, consumer groups, lenders, and academic researchers about the Dodd-Frank Act's counseling and HOEPA provisions.

We conducted this performance audit from August 2010 to July 2011 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. Appendix I explains our objectives, scope, and methodology in greater detail.

Background

Mortgage Markets and Securitization

Residential mortgages fall into several loosely defined categories and encompass a range of loan products:

- Prime mortgages are made to borrowers with strong credit histories and provide the most attractive interest rates and loan terms.
- Near-prime mortgages (also called Alt-A mortgages) generally serve borrowers whose credit histories are close to prime but who have one

or more higher-risk characteristics, such as limited documentation of income or assets.

- Subprime mortgages are generally made to borrowers with blemished credit and feature higher interest rates and fees than prime loans.

- Government-insured or -guaranteed mortgages primarily serve borrowers who may have difficulty qualifying for prime loans and feature interest rates similar to those for prime loans. These mortgages require insurance or charge guarantee fees. FHA and the Department of Veterans Affairs (VA) operate the two main federal programs that insure or guarantee mortgages.

Across all of these market segments, two types of loans are common: fixed-rate mortgages, which have interest rates that do not change over the life of the loans and ARMs, which have interest rates that change periodically based on changes in a specified index.

A number of loan features became more common in the 2000s. While these features potentially expanded access to mortgage credit, they were often associated with higher default rates. These features included the following:

- *Low- and no-documentation loans*. Originally intended for borrowers who had difficulty documenting income, such as the self-employed, these loans were made with little or no verification of a borrower's income or assets.

- *High LTV ratios.* As homebuyers made smaller down payments, this ratio increased.

- *Prepayment penalties.* Some loans contained built-in penalties for repaying part or all of a loan in advance of the regular schedule.

Other mortgage types that became more prevalent during this period included different types of ARMs. Short-term hybrid ARMs had a fixed interest rate for an initial period (usually 2 or 3 years) but then "reset" to an adjustable rate for the remaining term of the loan. Interest-only or payment-option ARMs allowed borrowers to defer repayment of principal and possibly part of the interest for the first few years of the loan.[12] Payment-option ARMs enabled mortgages to negatively amortize, meaning that the loan balance could increase over time.

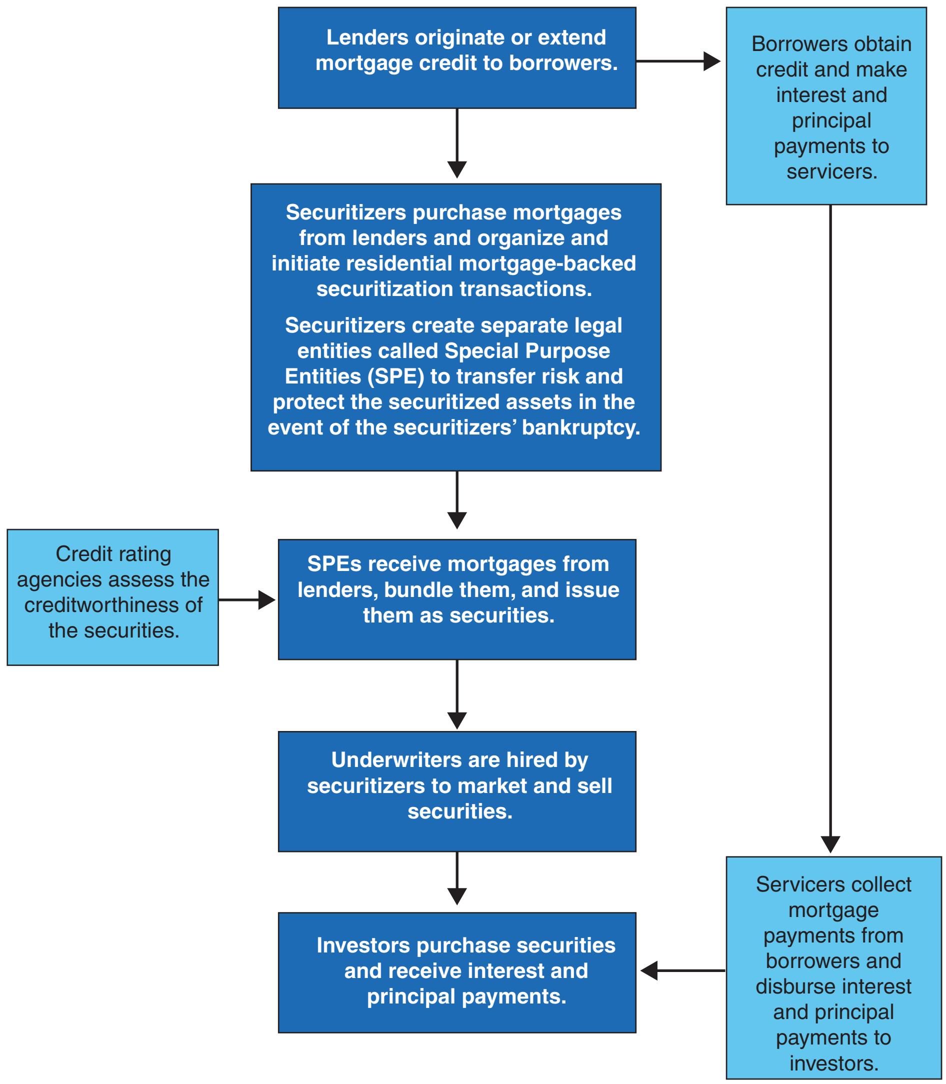
The secondary mortgage market, where loans are securitized, plays an important role in providing liquidity for mortgage lending. Securitization has a number of benefits for lenders. Among other things, it is typically less expensive than raising funds directly and it transfers some or all of the credit and interest rate risk from the lender to the investor.[13] To securitize mortgage loans, mortgage lenders or originators sell their loans to third parties—either directly to securitizing institutions or loan aggregators that serve as intermediaries between originators and securitizers—generating funds that could be used to originate more loans (see fig. 1). Securitization involves a number of players. Securitizing institutions include investment banks, retail banks, mortgage companies, and real estate investment trusts (REIT).[14] As a part of the securitization process, securitizers create a separate legal entity ("special purpose entity" or SPE) to bundle mortgages and sell them as investment products called RMBS. The purpose of creating the SPE is to help ensure that securitized assets are protected in the event of a bankruptcy of the securitizing or originating institutions. Other parties to a securitization transaction include, but are not limited to, credit rating agencies that assess the creditworthiness of the securities based on the likelihood of default and the expected value of dollar losses in the event of a default, and deal underwriters hired by the securitizers to market and sell the securities to investors. Finally, servicers are hired to collect mortgage payments from the borrowers and disburse interest and principal payments to the investors.

[12]GAO, *Alternative Mortgage Products: Impact on Defaults Remains Unclear, but Disclosure of Risks to Borrowers Could Be Improved*, GAO-06-1021 (Washington, D.C.: Sept. 19, 2006).

[13]Interest rate risk is the risk that an increase in interest rates will reduce the value of a fixed-rate loan.

[14]REITs are companies that own income-producing real estate and in some cases engage in financing real estate. To qualify as a REIT, a company must have most of its assets and income tied to real estate investment and must distribute at least 90 percent of its taxable income to shareholders annually in the form of dividends.

Figure 1: Basic Steps in the Securitization of Residential Mortgages



Source: GAO.

RMBS can be structured in different ways, but one common structure involves a prespecified distribution of cash payments to investors in different slices, or tranches of the security. Tranching allows investors with different appetites for risk to invest in a security with the same underlying pool of loans. In such credit-tranched structures, also known as "senior subordinate" structures, cash from the underlying loans is generally paid to the topmost, least risky tranche first until the prespecified thresholds are met. Cash then flows to the lower tranches in what is known as a "waterfall." Conversely, the bottom-most tranche typically absorbs the losses from defaults until it is depleted, with any additional losses flowing up toward senior securities.

The secondary mortgage market consists of (1) Ginnie Mae-guaranteed RMBS, which are backed by cash flows from federally insured or guaranteed mortgages; (2) enterprise RMBS, which are backed by mortgages that meet the criteria for purchase by Fannie Mae and Freddie Mac; and (3) private-label RMBS, which are backed by mortgages that do not conform to enterprise purchase requirements because they are too large (i.e., jumbo mortgages) or otherwise do not meet enterprise underwriting criteria. Most subprime and near-prime mortgages, and many prime jumbo mortgages, were securitized into private-label RMBS. However, the private-label market, which accounted for most of the RMBS issuances in 2005 and 2006, collapsed in 2008 and has not recovered. As a result, almost all RMBS issuances in recent years are backed by the full guarantees of the enterprises and Ginnie Mae. RMBS represent the biggest single piece of the larger securitization market, accounting for over one-third of all new asset-backed issuances from 2005 through the third quarter of 2010.

The composition of the mortgage market has changed dramatically in recent years. In the early to mid-2000s, the volume of subprime and near-prime mortgage originations grew rapidly and peaked in 2006, accounting for nearly 40 percent of mortgage originations that year.[15] These market segments contracted sharply in mid-2007, partly in response to increasing defaults and foreclosures, including mortgages defaulting within a few months of origination, and a lack of investor demand.[16] The market segments comprising mortgages backed by the enterprises and FHA had the opposite experience: a decline in market share in the early to mid-

[15]All of the market share figures in this paragraph are calculated based on data from Inside Mortgage Finance, are expressed in terms of dollar volume (rather than number of loans), and exclude home equity loans.

[16]For additional information about the characteristics and performance of subprime and near-prime mortgages, see GAO, *Nonprime Mortgages: Analysis of Loan Performance, Factors Associated with Defaults, and Data Sources*, GAO-10-805 (Washington, D.C.: Aug. 24, 2010). Lenders were often required by contract to repurchase mortgages for which the borrower failed to make a payment in the first 3 months after origination. Some lenders ended up in bankruptcy due to their inability to satisfy these repurchase requests.

2000s, followed by rapid growth beginning in 2007 and 2008, respectively.[17] For example, the enterprises' share of the mortgage market decreased from about one-half in 2003 to about one-third in 2006. By 2009 and 2010, enterprise-backed mortgages had increased to more than 65 percent of the market. Similarly, FHA-insured mortgages grew from about 2 percent of the market in 2006 to about 20 percent in 2009 and 2010. Congress and the administration are currently considering options to scale back the role of the enterprises and FHA in the mortgage market and increase the role of private capital. In addition to these potential changes, a recovery from constrained credit conditions in the mortgage market could expand the volume of mortgages extended to borrowers and therefore subject to the Dodd-Frank Act's provisions.

Federal Mortgage Lending Laws

The Dodd-Frank Act enacts numerous provisions intended to reform the mortgage lending industry with an eye toward consumer protection. Many of these provisions are contained in Title XIV of the act, which amends provisions of the Truth in Lending Act (TILA) to reform and provide accountability for consumer mortgage practices.[18] TILA, enacted in 1968, and HOEPA, which amended TILA in 1994, are among the primary federal laws governing mortgage lending. TILA was designed to provide consumers with accurate information about the cost of credit. Among other things, TILA requires lenders to disclose information about the terms of loans—including the amount financed, the finance charge, and the annual percentage rate (APR)—that can help borrowers understand the overall costs of their loans.[19]

Congress enacted HOEPA in response to concerns about predatory lending. HOEPA regulates and restricts the terms and characteristics of certain kinds of "high-cost" mortgages—that is, those that exceed certain thresholds in their APRs or fees (often referred to as "rate and fee triggers"). The Dodd-Frank Act expands the definition of high-cost loans

[17]FHA insures lenders against losses from borrower defaults on mortgages that meet FHA criteria. FHA historically has served borrowers who would have difficulty obtaining prime mortgages but in recent years has increasingly served borrowers with stronger credit histories.

[18]TILA, as amended, is codified at 15 U.S.C. §§ 1601 – 1666j.

[19]APR is a measure of credit cost to the borrower that takes account of the interest rate, points, and certain lender charges.

to include mortgages for purchasing a home; reduces the APR and points and fees triggers; and requires mandatory preloan counseling for borrowers of high-cost mortgages, among other things. The Federal Reserve Board implements TILA and HOEPA, but this responsibility will transfer to the Bureau of Consumer Financial Protection (also known as the Consumer Financial Protection Bureau or CFPB) on July 21, 2011.

Minimum Lending Standards and Qualified Mortgage Provisions

The Dodd-Frank Act reforms mortgage lending by amending TILA to prohibit lenders from making mortgage loans without regard to consumers' ability to repay them. As previously noted, lenders can comply with the ability-to-repay standard by originating a QM. Lenders are not prohibited from originating non-QMs, however. The Dodd-Frank Act specifies nine QM criteria, but gives the Federal Reserve Board the authority to add to, subtract from, or modify the criteria as it develops implementing regulations (see table 1).[20]

[20]The FHA, Department of Veterans Affairs (VA), and the Department of Agriculture's Rural Housing Service, in consultation with the Federal Reserve Board, are required to develop separate QM criteria for their loan programs through regulations. Additionally, rulemaking authority for TILA is scheduled to transfer to CFPB on July 21, 2011. Accordingly, the rulemaking for the QM provisions will be finalized by CFPB rather than by the Federal Reserve Board.

Table 1: Nine QM Criteria Specified in the Dodd-Frank Act

1.	Regular periodic payments do not result in an increase in the principal balance or result in a deferral of the repayment of principal (i.e., the mortgage cannot have a negative amortization feature or interest-only period).
2.	The loan term does not exceed 30 years. Rulemakers may extend loan terms beyond 30 years for certain locales, such as high-cost areas.
3.	Except for balloon loans under specified circumstances, the mortgage does not include balloon payments.[a]
4.	Borrower income and financial resources are verified and documented.
5.	The loans comply with guidelines or regulations established by the Federal Reserve Board relating to ratios of total monthly debt to monthly income or alternative measures of ability to pay regular expenses after paying monthly debt.
6.	A fixed-rate loan is underwritten based on a fully amortizing payment schedule that takes into account applicable taxes, insurance, and assessments.
7.	An ARM is underwritten based on the maximum rate permitted during the first 5 years and on a fully amortizing payment schedule that takes into account applicable taxes, insurance, and assessments.
8.	Total points and fees payable in connection with loan do not exceed 3 percent of the total loan amount.
9.	A reverse mortgage meets QM standards as set by the Federal Reserve Board.[b]

Source: Dodd-Frank Act.

[a]According to Dodd-Frank Act provisions and proposed QM rules issued in April 2011, some balloon mortgages can be considered to meet the QM criteria, such as balloon mortgages made by creditors that operate in predominantly rural or underserved areas.

[b] In proposed regulations, the Federal Reserve Board indicated that QM requirements were generally not relevant to reverse mortgages because the Dodd-Frank Act does not subject reverse mortgages to the ability-to-repay requirement (see 76 Fed. Reg. 27390, 27407 (May 11, 2011)). As a result, the Federal Reserve Board has not proposed QM standards for reverse mortgages at this time.

Risk Retention Requirement

The Dodd-Frank Act requires securitizers of RMBS to retain no less than 5 percent of the credit risk of any residential mortgage they securitize that does not meet specified criteria.[21] The purpose of the requirement is to help align the interests of participants in the securitization process and encourage sound loan underwriting. The Dodd-Frank Act exempts government-insured or -guaranteed mortgages from the risk retention requirement (excluding mortgages backed by the enterprises, which are in government conservatorship), and as noted previously, loans that meet the

[21]Dodd-Frank Act, sec. 941(b) (codified at 15 U.S.C. sec. 78o-11).

QRM criteria.[22] However, the Dodd-Frank Act requires that the risk retention requirement be applied to any RMBS that contains one or more non-QRMs, even if the vast majority of the security's mortgages are QRMs.

Federal banking and other agencies are required by the Dodd-Frank Act to jointly prescribe regulations for the risk retention requirement.[23] In crafting the risk retention regulations, the Dodd-Frank Act requires rulemakers to specify, among other things,

- criteria for QRMs, taking into consideration underwriting and product features that historical loan performance data indicate result in a lower risk of default thereby ensuring high-quality loan underwriting. The Dodd-Frank Act specifies that the QRM definition cannot be broader than the QM definition described previously (i.e., the QRM criteria can be more restrictive than the QM criteria but not less restrictive);
- permissible forms of risk retention and the minimum duration for meeting the requirement;
- ways of allocating risk between securitizers and originators; and
- the possibility of permitting a lower risk retention requirement (less than 5 percent) for any non-QRM that meets underwriting standards that the agencies develop in regulations.

[22]The act also does not apply the exemption for government-insured or –guaranteed mortgages to mortgages backed by Federal Home Loan Banks, which form a system of regional cooperatives that support housing finance through advances and mortgage programs, among other activities.

[23]The federal banking agencies (with the exception of NCUA), FHFA, HUD, and SEC must jointly issue regulations related to the risk retention provisions of the Dodd-Frank Act as they pertain to residential mortgages. For the purposes of the Dodd-Frank Act, the federal banking agencies include FDIC, the Federal Reserve Board, and OCC.

Rulemakers issued proposed rules for the risk retention provisions in March 2011.[24] The proposed criteria for the QRM include, but are not limited to, the following:

- the LTV ratio must be at least 80 percent for mortgages obtained for a home purchase;[25]
- the DTI ratio must be 36 percent or less;[26]
- the loan term must not exceed 30 years;
- the loan cannot include negative amortization or payment deferral features;
- points and fees cannot exceed 3 percent of the total loan amount;
- the borrower can neither be 30 or more days past due on any debt obligation nor have been 60 or more days past due on any debt obligation within the preceding 24 months; and
- the originator must incorporate into the mortgage documents certain requirements regarding policies and procedures for servicing the mortgage, including procedures to promptly initiate activities to mitigate the risk of default for delinquent loans.[27]

Although this report focuses on risk retention for RMBS, the Dodd-Frank Act's risk retention requirement also applies to securities backed by other

[24]See 76 Fed. Reg. 24090 (Apr. 29, 2011). Under the Dodd-Frank Act, the risk retention requirement also applies to other asset classes.

[25]The proposed rules also contain an LTV ratio cap of 70 percent for cash-out refinance mortgages (i.e., refinancing at a higher amount than the loan balance to convert home equity into money for personal use) and 75 percent for rate and term refinance mortgages (i.e., refinancing to change the interest rate or length of the mortgage with no cash out).

[26]The proposed criteria for the QRM also specify a maximum level of 28 percent for the percentage of a borrower's income that goes toward mortgage and other housing-related payments such as private mortgage insurance, property taxes, and homeowner association fees.

[27]The proposed rules also request public comments on a possible alternative approach to QRMs. This approach would allow QRMs to have higher LTV and DTI ratios than those described above and take into account mortgage insurance or other third-party credit enhancements. Non-QRMs would be subject to stricter (e.g., less flexible or higher) risk retention requirements than described in the main approach.

asset classes, such as credit cards and automobile loans. In response to a mandate in the Dodd-Frank Act, the Federal Reserve Board issued a report in October 2010 that, among other things, describes historical issuance activity, securitization structures, and incentive alignment mechanisms for nine categories of asset-backed securities.[28] The report noted that the effects of a final set of risk retention requirements could not be analyzed because implementing regulations were still being developed. However, the report made a number of recommendations for rulemakers to consider when crafting the risk retention requirement, including a recommendation that the requirement be tailored to each major class of securitized assets. Also in response to a mandate in the Dodd-Frank Act, the Chairman of the Financial Stability Oversight Council issued a report in January 2011 that examined the macroeconomic effects of a risk retention requirement. While noting limitations in the information available to assess the impacts of risk retention rules not yet in place, the report offered several principles and recommendations to inform the design of a risk retention framework that facilitates economic growth by allowing market participants to price credit risk more accurately and allocate capital more efficiently.[29]

Housing Counseling

The Housing and Urban Development Act of 1968 authorized HUD to provide housing counseling services.[30] Specifically, it authorized HUD to make grants to or contract with public or private organizations to provide a broad range of housing counseling services to homeowners and

[28]Dodd-Frank Act, sec. 941(c). Board of Governors of the Federal Reserve System, *Report to the Congress on Risk Retention* (October 2010), available at http://www.federalreserve.gov/newsevents/press/other/20101019a.htm.

[29]Dodd-Frank Act, sec. 946. Financial Stability Oversight Council, *Macroeconomic Effects of Risk Retention Requirements* (January 2011), available at http://www.treasury.gov/press-center/press-releases/Pages/tg1027.aspx.

[30]12 U.S.C. 1701x.

tenants to assist them in improving their housing conditions and in meeting the responsibilities of homeownership or tenancy.[31]

The Dodd-Frank Act requires HUD to establish an Office of Housing Counseling and gives the office a broad range of responsibilities relating to homeownership and rental housing counseling, including grant administration, policy development, public outreach, and research.[32] The Dodd-Frank Act requires HUD to appoint a Director of Housing Counseling to report directly to the Secretary of HUD and to establish an advisory committee consisting of mortgage and real estate industry stakeholders and consumer groups and HUD-certified housing counseling agencies.

Two key types of homeownership counseling are foreclosure mitigation counseling and prepurchase counseling. Foreclosure mitigation counseling focuses on helping financially distressed homeowners avoid foreclosure by working with lenders to cure mortgage delinquency. Prepurchase counseling topics can include the process of qualifying for a mortgage, selecting a mortgage product, and successfully maintaining a home. While prepurchase

[31]Several other federal agencies also provide limited support or funding for housing counseling, often for specific populations, including the Departments of Defense (DOD) and the Treasury (Treasury) and the VA. For example, Treasury provided funding for financial education and counseling through the Financial Education and Counseling Pilot Program, authorized pursuant to Section 1132 of the Housing and Economic Recovery Act of 2008 (Pub. L. 110-289). Through this program, Treasury awarded grants to nine eligible organizations, including HUD-approved housing counseling agencies. Grant recipients are required to identify successful methods of financial education and counseling services that result in positive behavioral change for financial empowerment and to establish program models for organizations to deliver effective financial education and counseling services to prospective homebuyers. Congress appropriated $2.0 million for the program in fiscal year 2009 and $4.15 million in fiscal year 2010. P.L. 110-289 also directed DOD to set up a foreclosure counseling program for servicemembers returning from active duty abroad. Similarly, the VA employs loan counselors through its nine Regional Loan Centers to help veterans who are facing foreclosure or other financial problems. The VA's counselors assist veterans whether or not their mortgages are guaranteed by the VA. The VA also relies on HUD's housing counseling program for prepurchase housing counseling.

[32]The Dodd-Frank Act also requires the CFPB to establish an Office of Financial Education to improve financial literacy through activities that include financial counseling. The duties this office is charged with are in some ways similar to those of the separate Office of Financial Education and Financial Access within Treasury. We have previously reported on the need for federal entities to coordinate their roles and activities to avoid unnecessary overlap and duplication. See GAO, *Financial Literacy: The Federal Government's Role in Empowering Americans to Make Sound Financial Choices*, GAO-11-504T (Washington, D.C.: Apr. 12, 2011).

counseling was common prior to the financial crisis, foreclosure mitigation counseling has gained increasing attention and popularity as a means to assist homeowners who are struggling to stay in their homes.

Although Most Recent Mortgages Would Likely Have Met Certain Qualified Mortgage Criteria, the Criteria Could Limit Mortgage Options for Some Borrowers

Our analysis of the QM criteria specified in the Dodd-Frank Act generally indicated that, for each year from 2001 through 2010, most mortgages would likely have met the individual criteria for which relevant data were available.[33] The extent to which mortgages met individual criteria varied by mortgage category and origination year, reflecting changes in the mortgage market over the 10-year period. Consumer and industry groups that we spoke with noted that the QM criteria would likely provide several benefits to qualified borrowers, and housing research indicates that many of the QM criteria are associated with a borrower's ability to repay a mortgage. However, some consumer and industry groups stated that some of the QM criteria could increase the cost and restrict the availability of mortgages for some borrower groups, including lower-income and minority borrowers.

Data on a Cross Section of Mortgages Suggest That Most Mortgages Would Have Met Selected Qualified Mortgage Criteria Specified in the Dodd-Frank Act

To illustrate the potential significance of the QM criteria under different lending environments and market conditions, we applied selected criteria to CoreLogic data on mortgages originated from 2001 through 2010. We applied each criterion separately, calculating the proportion of mortgages in each annual loan origination cohort that likely would have met it. We were unable to determine the proportion of mortgages that would have met all of the criteria we examined due to the number of records in the database that had missing or unreliable values for one or more of the criteria. For example, the database contained no information on DTI ratio for subprime mortgages and did not have reliable information on documentation of borrower income and assets.[34] As a result, we determined that applying the criteria simultaneously would not have produced reliable results. Because the CoreLogic data group mortgages into two broad categories—the first containing prime, near-prime, and

[33]As previously noted, the CoreLogic database we used for this analysis covers a broad cross-section of the mortgage market. However, because of limitations in the coverage and completeness of the data, our analysis may not be fully representative of the mortgage market as whole.

[34]As discussed later in this section, we relied on other data sources to examine the proportion of mortgages that would have met the QM criterion for full documentation.

government-insured or -guaranteed loans and the second containing subprime loans—we examined these categories separately when possible.[35] The data did not contain information needed to examine all of the QM criteria specified in the Dodd-Frank Act. As a result, our analysis focused on the five criteria for which CoreLogic or other data were available. Our analysis includes other limitations and assumptions, as discussed in the rest of this section and in appendix I. Additionally, appendix II contains additional breakdowns of our analysis by geographic groupings based on racial, ethnic, income, and house price patterns.

The five QM criteria in the Dodd-Frank Act that we were able to assess were

- regular periodic payments do not result in an increase in the principal balance or deferred repayment of principal (e.g., due to negative amortization features);
- the loan term does not exceed 30 years;[36]
- except for balloon loans under specified circumstances, the loan does not include balloon payments;[37]
- borrower income and financial resources are verified and documented; and
- the loan complies with guidelines or regulations established by the Federal Reserve Board relating to ratios of total monthly debt service to monthly income. The Federal Reserve Board's proposed rules for

[35]In terms of dollar volume, mortgages in the first category accounted for roughly 90 percent of mortgage originations from 2001 through 2003. This proportion declined to approximately 77 percent in 2005 and 2006, then rose from about 91 percent in 2007 to almost 100 percent in 2009 and 2010. For ease of presentation, we refer to mortgages with government insurance or guarantees as government-insured mortgages in the remainder of this report.

[36]As previously noted, rulemakers may extend loan terms beyond 30 years for certain locales, such as high-cost areas.

[37]As previously noted, the Dodd-Frank Act defines a balloon payment as a scheduled payment that is more than twice as large as the average of earlier scheduled payments. According to proposed QM rules issued in April 2011, some balloon mortgages can be considered to meet the QM criteria, such as balloon mortgages with terms of 5 or more years made by creditors that operate in predominantly rural or underserved areas.

QMs do not provide a specific DTI ratio.[38] Therefore, for illustrative purposes, we used the 41-percent ratio that serves as a guideline in underwriting FHA-insured mortgages.

Negative Amortization Features

The significance of selected QM requirements varied by origination year. Regarding the criterion for repayment of principal, our analysis focused on mortgages with negative amortization features, which would have been prohibited under the Dodd-Frank Act because they allowed payments that did not cover the loan principal, resulting in increasing loan amounts. Due to limitations in the CoreLogic data, our analysis does not account for interest-only mortgages, which would also have been prohibited because they deferred repayment of principal.[39] Negative amortization features can be problematic because borrowers may experience payment shock when their payments increase to include an amount that will fully amortize the outstanding balance over the remaining loan term. As shown in figure 2, most mortgages originated from 2001 through 2010 would have met the QM requirement related to repayment of principal. Among prime, near-prime, and government-insured mortgages, the proportion of new originations without a negative amortization feature declined from 99 percent in 2001 to 91 percent in 2005, then increased to essentially 100 percent in 2009 and 2010. This trend reflects the growth in near-prime mortgages (many of which were payment-option ARMs that could negatively amortize) early in the decade and their disappearance after 2007. In the subprime market, almost 100 percent of mortgage originations from 2001 through 2007 did not have negative amortization features. Because so few subprime mortgages were originated after 2007, we did not calculate corresponding percentages for 2008 through 2010 for this criterion or other QM criteria.

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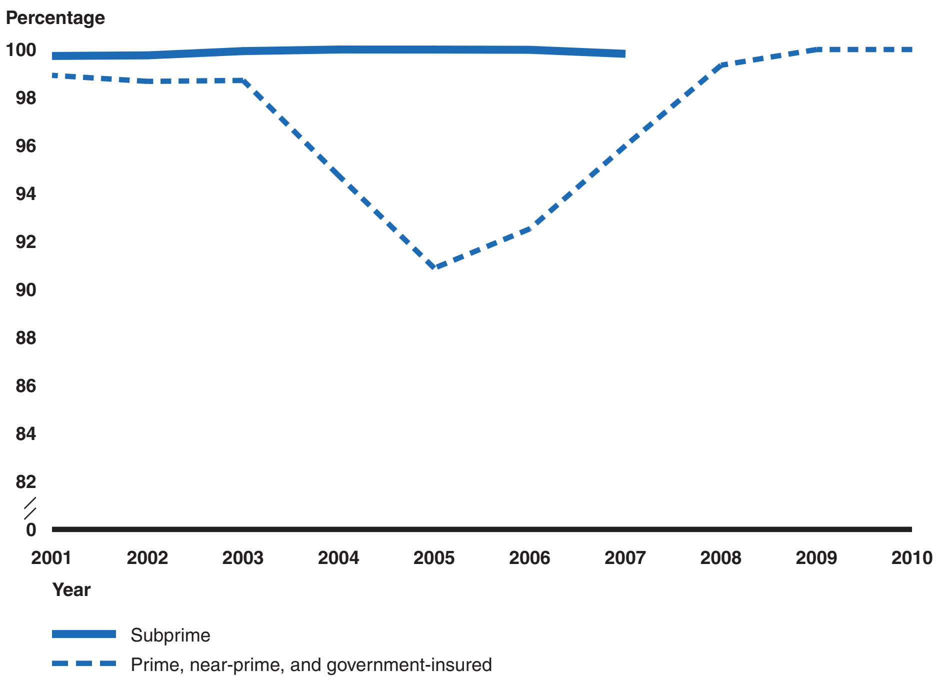
[38]The proposed rules describe two alternative sets of QM criteria: one that does not include DTI ratio, and one that requires consideration of DTI ratio.

[39]Although most of the mortgages in the CoreLogic dataset had missing values for the interest-only indicator, the data suggest that the interest-only feature was especially prominent among prime and near-prime hybrid ARMs, a product type that became more common in the mid-2000s. An FHFA analysis covering the period from 2006 through 2010 indicates that interest-only mortgages accounted for about 15 percent of Fannie Mae's mortgage purchases in 2006 but that this percentage declined to 0 to 1 percent in 2009 and 2010. The analysis showed that for Freddie Mac, the percentage of interest-only mortgages peaked in 2007 at 22 percent before falling to 0 percent in 2009 and 2010. See FHFA, *Conservator's Report on the Enterprises' Financial Performance, Fourth Quarter 2010,* available at http://www.fhfa.gov/Default.aspx?Page=172.

Figure 2: Proportions of Mortgages Meeting Qualified Mortgage Repayment of Principal Requirement, 2001-2010



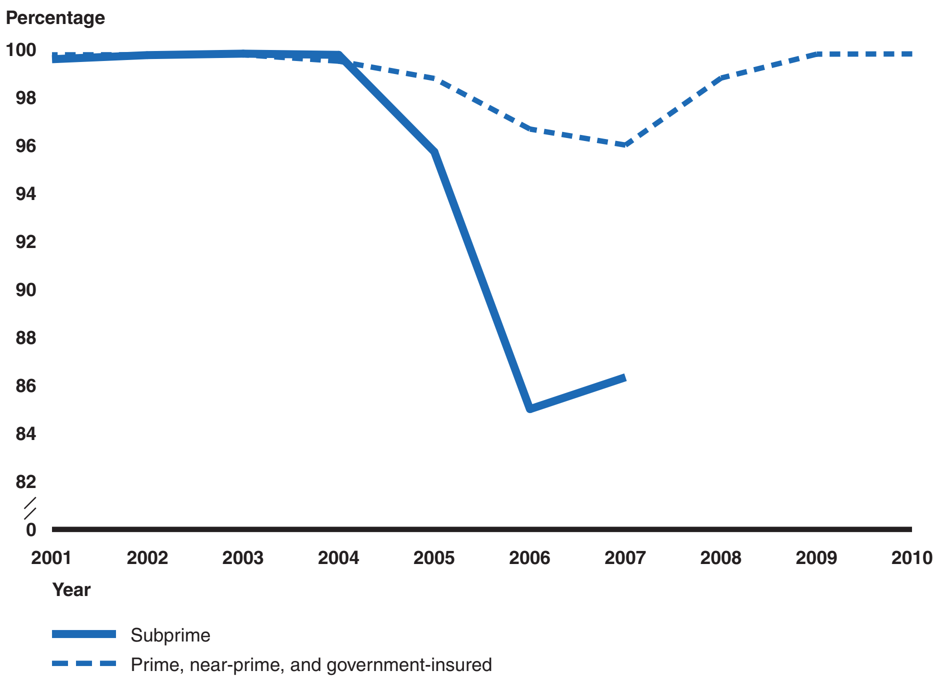
Source: GAO analysis of CoreLogic data.

Note: We do not report percentages for subprime mortgages after 2007 due to the low number of originations. The figure does not account for interest-only mortgages, which would also be prohibited because they defer repayment of principal. The CoreLogic database we used for this analysis covers a broad cross-section of the mortgage market. However, because of limitations in the coverage and completeness of the data, our analysis may not be fully representative of the mortgage market segments shown.

Loan Term

As shown in figure 3, the large majority of mortgages originated from 2001 through 2010 would have met the QM criterion for a loan term of 30 years of less. A term of greater than 30 years increases the borrower's total mortgage costs because more interest accrues than it would in a shorter period. Among prime, near-prime, and government-insured mortgages, essentially 100 percent met the criterion from 2001 through 2004. For this category of mortgages, the proportion declined to 96 percent in 2007 and rose back to about 100 percent by 2009. For subprime mortgages, the proportion that met the criterion was nearly 100 percent from 2001 through 2004, but declined to 85 percent in 2006. The trend in the middle of the decade toward mortgages with longer loan terms suggests efforts by lenders to qualify borrowers for mortgages that offered lower monthly payments during a period of strong appreciation in house prices.

Figure 3: Proportions of Mortgages Meeting Qualified Mortgage Requirement for Loan Terms of 30 Years or Less, 2001-2010



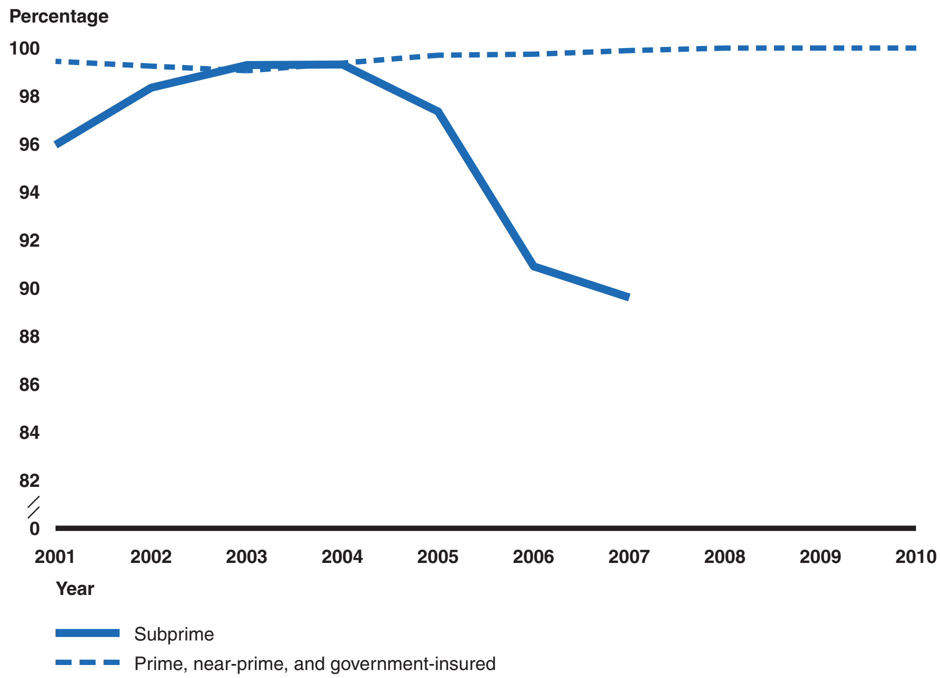
Source: GAO analysis of CoreLogic data.

Note: We do not report the proportion of subprime mortgages after 2007 due to the low number of subprime originations. The CoreLogic database we used for this analysis covers a broad cross-section of the mortgage market. However, because of limitations in the coverage and completeness of the data, our analysis may not be fully representative of the mortgage market segments shown.

Balloon Payments

A high proportion of the mortgages originated over the 10-year period we examined would have met the QM criterion restricting balloon payments, although the percentages were somewhat different for prime, near-prime, and government-insured mortgages compared with subprime mortgages (see fig. 4). A balloon mortgage does not fully amortize over the term of the loan, leaving a balance due at maturity. The final payment is called a balloon payment because it is generally much larger than the other payments. Mortgages with balloon payments have been associated with repayment problems, likely due to the payment shock that occurs when the loan balance becomes due, or difficulty in refinancing at the end of the loan term, especially if the home value depreciated. Among prime, near-prime, and government-insured mortgages, almost 100 percent of the originations each year did not have balloon payments. For subprime mortgages, the proportions increased from 96 percent in 2001 to 99 percent in 2003 and 2004, and decreased to about 90 percent in 2007.

Figure 4: Proportions of Mortgages Meeting Qualified Mortgage Restriction on Balloon Payments, 2001-2010



Source: GAO analysis of CoreLogic data.

Note: We do not report the proportion of subprime mortgages after 2007 due to the low number of subprime originations. The CoreLogic database we used for this analysis covers a broad cross-section of the mortgage market. However, because of limitations in the coverage and completeness of the data, our analysis may not be fully representative of the mortgage market segments shown.

Full Documentation

A majority of the mortgages originated from 2001 through 2010 would likely have met the QM criterion for full documentation of borrower income and other financial resources, although low- or no-documentation loans became common in certain market segments in the middle of the decade. Low- or no-documentation of income or assets allows borrowers to provide less detailed financial information than is traditionally required. This feature was originally intended for borrowers who might have difficulty documenting income, such as the self-employed, but eventually became more widespread in the mid-2000s. As we previously reported, mortgage originators or borrowers may have used the limited documentation feature in some cases to overstate the financial resources of borrowers and qualify them for larger, potentially unaffordable loans.[40]

The CoreLogic data on documentation level were not sufficiently reliable for our purposes, but information from other sources provides some insights on documentation practices during the 10-year period we examined. FHFA analysis of mortgages purchased by the enterprises from 2001 through 2010 indicates that the proportion of mortgages originated each year that were not “Alt-A,” and therefore most likely to have met the full documentation criterion, ranged from a low of about 80 percent in 2006 (when enterprise-purchased mortgages accounted for about one-third of the market) to a high of 100 percent in 2010 (when the enterprises represented about two-thirds of the market).[41] According to FHA policy, all FHA-insured mortgages, except the generally modest proportion that are streamlined refinances (expedited refinancing from one FHA-insured loan into another), are fully documented. As previously noted, FHA-insured mortgages accounted for about 20 percent of new originations in 2009 and 2010 but for a substantially smaller share in prior years. As we have previously reported, smaller proportions of subprime and near-prime mortgages—which together grew to about 40 percent of mortgage originations in 2006 but mostly disappeared after 2007—had full documentation. Specifically, from 2001 to 2007, the proportion of subprime mortgages with full documentation ranged from about 60 percent (in 2006) to 80 percent (in 2001), while the corresponding proportion for near-prime mortgages ranged from about 20 percent (in 2006 and 2007) to just over 40 percent (in 2002).

[40] GAO-10-805.

[41] Alt-A generally refers to a mortgage loan originated under a lender’s program offering reduced or alternative documentation than that required for a full documentation mortgage loan but may also include other alternative product features. Both enterprises classify mortgages as Alt-A if the lenders delivering the mortgages classify them as Alt-A based on documentation or other product features.

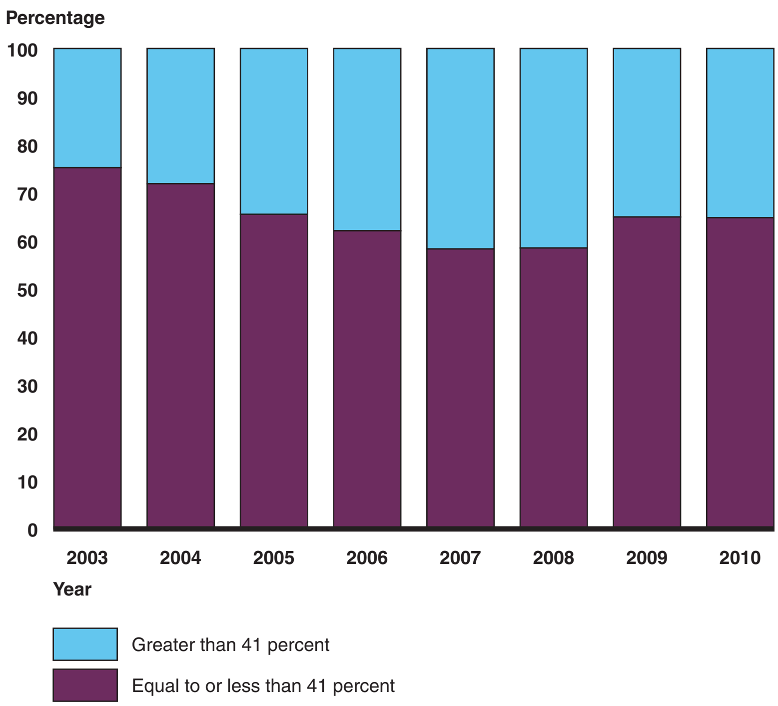
Debt Service-to-Income Ratio

Using an illustrative standard of 41 percent or less for the QM criterion for DTI ratio, we found that more than half of the mortgages originated from 2003 through 2010 for which reported DTI ratios were available would likely have met the criterion; however, a sizable proportion—from 25 to 42 percent—would not have.[42] We did not calculate corresponding percentages for 2001 and 2002 because our CoreLogic data sample lacked DTI information for the large majority of the mortgages originated in those years. The DTI ratio is a key measure of a borrower's debt burden and is therefore a factor used in assessing a borrower's ability to repay a loan. The proportion of prime, near-prime, and government-insured mortgages that would have met the illustrative 41-percent criterion decreased from about 75 percent in 2003 to 58 percent in 2008 and then increased to about 65 percent in 2009 and 2010 (see fig. 5). Although the CoreLogic database we used did not have DTI information for subprime mortgages, we have previously reported that subprime mortgages originated from 2001 through 2005 had average reported DTI ratios of less than 41 percent and that those originated in 2006 and 2007 had average reported DTI ratios of 41.1 and 41.5 percent, respectively.[43] As a result, a substantial proportion of subprime mortgages would not have met a 41-percent criterion.

[42]According to OCC officials, mortgage originators may have calculated DTI ratios differently depending on their definitions of debt and income. The officials also indicated that in some cases, mortgage originators used mortgage payments that did not fully amortize the mortgage to determine a borrower's total recurring debt payments and that borrower income was sometimes overstated for mortgages without full documentation of income. As a result, the proportions of mortgages we show as meeting the criterion are likely somewhat higher than they would have been if all of the DTI ratios had been calculated in a uniform and accurate manner.

[43]GAO-09-848R.

Figure 5: Proportions of Prime, Near-Prime, and Government-insured Mortgages Meeting Illustrative Qualified Mortgage Criterion for a Debt Service-to-Income Ratio of 41 Percent or Less, 2003-2010



Source: GAO analysis of CoreLogic data.

Notes: Percentages reflect only those mortgages for which data were available. About half of the mortgages in our CoreLogic data sample did not have information on the DTI ratio for 2003 through 2010. We concluded that those mortgages were likely not systematically different from mortgages with DTI information based on a comparison of the distribution of borrower credit scores associated with both groups of mortgages, which showed little difference. Additionally, the percentages shown are based on reported DTI ratios, which may understate debt obligations or overstate income in some cases. As a result, the proportions of mortgages we show as meeting the criterion are likely somewhat higher than they would have been if all of the DTI ratios had been calculated in a uniform and accurate manner. The Dodd-Frank Act does not specify a maximum DTI ratio for QMs and authorizes rulemakers to establish one. The CoreLogic database we used for this analysis covers a broad cross-section of the mortgage market. However, because of limitations in the coverage and completeness of the data, our analysis may not be fully representative of the mortgage market segments shown.

Other Qualified Mortgage Criteria

Our analysis suggests that for each year from 2001 through 2010, most borrowers obtained mortgages with characteristics consistent with the individual QM criteria we were able to examine. However, we were not able to evaluate other QM criteria because of data limitations, and rulemaking agencies have not yet established the final QM criteria. The four criteria we were unable to examine were as follows:

- underwriting for fixed-rate mortgages is based on a fully amortizing payment schedule that takes into account applicable taxes, insurance, and assessments;
- underwriting for ARMs must be based on the maximum interest rate allowed during the first 5 years and must take into account applicable taxes, insurance, and assessments;
- total points and fees cannot exceed 3 percent of the total loan amount; and
- reverse mortgages must meet standards established by the Federal Reserve Board.

The first two criteria address the practice of some lenders that qualified borrowers for mortgages without assessing their ability to pay taxes and insurance or make monthly payments that reflected scheduled increases in interest rates.[44] Requiring that underwriting account for applicable taxes and insurance could help ensure that borrowers can meet their responsibilities for paying these costs in addition to their mortgage payment.[45] Similarly, requiring underwriting to be based on the maximum interest rate allowed during the first 5 years could help ensure that borrowers have the ability to pay scheduled increases in mortgage payments. Limiting points and fees may protect borrowers against excessive up-front charges that have been associated with predatory lending practices. We were not able to examine the criterion concerning reverse mortgages because the Federal Reserve Board did not propose

[44]By one estimate, about three-quarters of subprime borrowers lack escrow accounts, which are bank accounts set up by lenders into which monthly payments from the borrower are deposited for property taxes.

[45]In March 2011, the Federal Reserve Board issued a proposal to implement Sections 1461 and 1462 of the Dodd-Frank Act, which provide certain escrow requirements for higher-priced loans.

standards for them. In proposed regulations, the Federal Reserve Board indicated that QM requirements were generally not relevant to reverse mortgages because the Dodd-Frank Act does not subject reverse mortgages to the ability-to-repay requirement.

The Dodd-Frank Act gives the Federal Reserve Board the authority to add to, subtract from, or modify the QM criteria as implementing regulations are developed. Additionally, the Department of Agriculture's Rural Housing Service, FHA, and VA are required to develop separate QM criteria for their loan programs through regulations. The Federal Reserve Board issued proposed QM rules in April 2011, and is accepting public comments through July 22, 2011. The Dodd-Frank Act requires that the rules be finalized by no later than January 2013.

Consumer and Industry Groups Cited Consumer Protection Benefits of the Qualified Mortgage Criteria but also Raised Some Concerns

Representatives from some consumer groups and the mortgage industry we spoke with stated that they were generally supportive of certain QM criteria in the Dodd-Frank Act because the criteria were associated with a borrower's ability to repay a mortgage. Representatives from one of the mortgage industry associations stated that the criteria were consistent with their responsible lending policy, which was based upon a consumer's ability to repay. Several consumer group representatives stated that providing mortgages based upon a borrower's ability to repay would ultimately benefit consumers by providing them with sustainable products, such as 30-year fixed-rate mortgages, that were easy to understand. In addition, some indicated that QMs would protect eligible consumers from risky loan features, such as abrupt interest rate increases that could cause payment shock. Also, one consumer group indicated that the QM criteria could increase the availability of affordable and sustainable mortgage credit by encouraging lender competition in offering less risky mortgage products and helping to increase investor confidence in private-label RMBS.

Consistent with these views, research indicates that certain QM criteria specified in the Dodd-Frank Act are associated with a borrower's ability to meet their mortgage obligations. For example, we and others have previously reported that no- and low-documentation mortgages are associated with higher probabilities of default and foreclosure, likely because borrowers' financial resources were sometimes overstated, allowing for larger, potentially unaffordable loans.[46] Additionally, some

[46] GAO-10-805.

research indicates that balloon payments are associated with poorer loan performance, as some lenders may use them to induce borrowers into mortgages with attractive monthly payments without disclosing their long-term consequences. A 2007 study estimated that, controlling for other factors, subprime refinance mortgages with balloon payments were 50 percent more likely to experience a foreclosure than other loans.[47] We previously reported that mortgages with payment options that allowed for negative amortization (by adding deferred interest payments to the loan balance) could lead to payment shock when the interest-only or payment option period expired.[48] Homeowners who could not afford the higher payments were more likely to enter foreclosure.

However, several of the mortgage industry representatives told us that the QM criterion limiting total points and fees to 3 percent of the total loan amount could increase the cost and decrease the availability of mortgages for certain borrower groups, including otherwise qualified low-income and minority borrowers. According to these representatives, because certain costs for originating a mortgage are fixed (i.e., do not vary with the size of the loan), points and fees on smaller loans can easily exceed 3 percent of the total (e.g., loans of $150,000 or less, according to one lender). These representatives stated that a possible consequence of the cap could be that lenders would increase interest rates on smaller loans or be deterred from making them altogether. They indicated that this outcome could disproportionately affect populations that tend to take out smaller mortgages such as lower-income, first-time, rural, and minority borrowers.

Several mortgage industry representatives also raised concerns about the QM criteria that restrict mortgages with balloon payments and create stricter underwriting standards for ARMs. According to these representatives, both product types—which typically have lower initial interest rates or monthly payments than comparable fixed-rate mortgages—can be used responsibly under certain circumstances to make mortgages more affordable in the short run. These representatives said that these criteria could constrain mortgage options or delay

[47]Robert G. Quercia, M. Stegman, and W. Davis, "The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments," *Housing Policy Debate*, vol. 18, no. 2 (2007).

[48]GAO-08-78R.

homeownership for borrowers that traditionally used such products, including some rural and lower-income borrowers.[49]

Concerns were also raised about DTI ratio requirements. While the Dodd-Frank Act does not provide a maximum DTI ratio, it states that the QM criteria must comply with any guidelines or regulations established by the Federal Reserve Board relating to ratios of total monthly debt service to monthly income (or alternative measures).[50] Several mortgage industry representatives stated that QM criteria that include specific DTI ratios could restrict the availability of QMs for retirees or those with irregular income streams. Industry representatives that we met with also indicated that some retirees might have small incomes but substantial assets to draw upon to meet their mortgage obligations and that individuals with irregular incomes, such as seasonal workers, could have trouble meeting income documentation requirements. As a result, some creditworthy borrowers might be prevented from obtaining QMs.

Representatives from several construction and mortgage industry associations stated that the QM criteria could restrict new home construction and mortgage refinancing. They said that the QM criteria could make qualifying for a mortgage more difficult for some borrowers, reducing demand for newly constructed homes. In addition, officials from two mortgage industry associations stated that the QM criteria could make it more difficult or expensive for some existing homeowners to refinance their mortgages. In particular, the QM criteria could affect homeowners who did not qualify for a QM or who could not take advantage of “streamlined refinance” programs—which allow qualified borrowers to refinance with their existing lenders with less than full

[49]ARMs with initial fixed-rate periods of less than 5 years became a common product type during the mid-2000s. They accounted for over one-third of the first-lien mortgages in our CoreLogic data sample that were originated in 2005.

[50]As previously noted, the Federal Reserve Board’s proposed QM rules do not provide a specific DTI ratio. Rather, they describe two alternative sets of QM criteria: one that does not include DTI ratio, and one that requires consideration of DTI ratio.

documentation and with reduced fees—because of Dodd-Frank Act requirements for full documentation of borrower income and assets.[51]

Finally, a number of mortgage industry representatives expressed concerns about the extent to which QMs would protect lenders from legal claims by borrowers that the originating lenders had not complied with the Dodd-Frank Act's ability-to-repay standard. Although the Dodd-Frank Act provides some measure of protection from liability for lenders of QMs, industry representatives we spoke with told us that it was unclear whether that protection was intended to be a legal "safe harbor" from liability— an interpretation they favored—or a "rebuttable presumption of compliance" with the ability-to-repay standard. A rebuttable presumption would allow borrowers to overcome the presumption of compliance by providing evidence that the lender did not, in fact, make a reasonable and good faith determination of the borrower's ability to repay the loan. Consumer group representatives told us that they favored this interpretation.

In April 2011, the Federal Reserve Board issued proposed regulations concerning criteria for complying with the ability-to-repay standard, including by originating a QM, and that addressed some of the concerns related to the DTI ratio, the cap on points and fees, and balloon loans. The proposed rules include two alternative definitions of a QM. To help decide on a final definition, the Federal Reserve Board is soliciting public comments on these two alternatives and invites proposals for other definitions. The first alternative in the proposed rule operates as a legal safe harbor and includes all of the QM criteria described in the Dodd-Frank Act, with the exception of the DTI ratio. The rules note that due to the discretion inherent in making DTI ratio calculations, a requirement to consider the DTI ratio would not provide certainty that a loan is a QM. The second alternative provides a rebuttable presumption of compliance and includes the QM criteria identified under the first alternative, as well as

[51]The Dodd-Frank Act allows streamlined refinancing without verification of borrower income and assets in cases where the borrower is refinancing from a "nonstandard mortgage" into a "standard mortgage" with the same lender. According to the Federal Reserve Board's proposed implementing rules, a nonstandard mortgage is (1) an ARM with an introductory fixed rate for a period of years, (2) an interest-only loan, or (3) a negative amortization loan. A standard mortgage is one that does not have a negative amortization, interest-only, or balloon payment feature and that limits the points and fees. The consumer's monthly payment must be reduced through the refinancing and the consumer must not have had more than one payment more than 30 days late on the existing nonstandard mortgage during the 24 months preceding the application for the standard mortgage.

other underwriting criteria—including consideration of borrower DTI ratio or residual income, employment status, simultaneous loans, current debt obligations, and credit history—drawn from the Dodd-Frank Act's ability-to-repay standard. The proposed rules also describe adjustments to and exclusions from the 3 percent cap on points and fees (including for smaller loans) and the restrictions on balloon payments for rural and underserved areas.

Regulatory Decisions and Other Factors Will Influence the Effect of a Risk Retention Requirement on the Mortgage Market

The risk retention requirement is intended to help align the interests of key participants in the securitization market—securitizers, lenders, and investors—and encourage sound loan underwriting. The requirement mandates that securitizers of RMBS have an economic stake in the securities they issue and therefore an incentive to ensure that lenders originate well-underwritten mortgages that protect investors from losses. Many industry stakeholders and consumer groups noted that the implications of such a requirement would depend on a variety of regulatory decisions and potential changes in the mortgage market. These include decisions on the characteristics of QRMs that would be exempt from the risk retention requirement, the forms of risk retention that would be allowed, the percentage that securitizers would be required to hold, and risk-sharing arrangements between securitizers and lenders. These factors could affect the availability and cost of mortgage credit and the future viability of the private-label RMBS market. Some market participants and the rulemaking agencies noted that risk retention may complement other securitization and mortgage reforms, such as those that promote greater transparency and enforcement of loan underwriting standards. Interactions between a risk retention requirement and future changes to the federal government's role in housing finance could also affect the cost of mortgage credit and the private-label RMBS market.

Regulatory Decisions on Mortgage Characteristics Will Affect the Scope and Implications of the Risk Retention Requirement

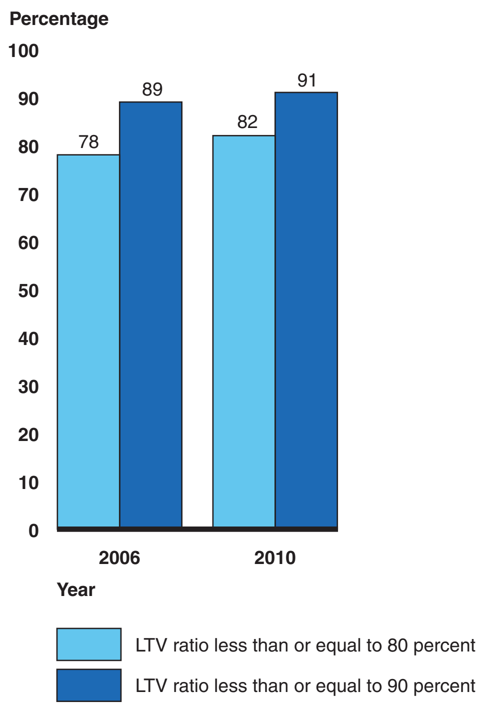
Mortgage market participants and consumer groups that we interviewed indicated that the effect of the risk retention requirement would depend in large part on certain regulatory decisions. Rulemaking agencies are accepting public comments on proposed risk retention regulations through August 1, 2011. Restrictive criteria would limit QRMs to mortgages with high credit quality, while less restrictive criteria would expand QRMs to include mortgages with a wider range of credit quality. Regulators' decisions about the criteria will determine the proportion of securitized mortgages that are exempt from a risk retention requirement and could affect the availability and cost of mortgage credit for non-QRM borrowers. The Dodd-Frank Act requires the rulemaking agencies to establish the definition by considering mortgage underwriting and product features that historical loan performance data indicate result in a lower risk of default. The rulemaking agencies are considering a range of features, including LTV and DTI ratios. Lower LTV ratios (indicative of larger borrower down payments) and lower DTI ratios (indicative of smaller borrower debt burdens) would represent more restrictive criteria.

To illustrate the potential impact of more and less restrictive QRM criteria on the mortgage market, we used the CoreLogic data to calculate the proportion of mortgages meeting certain LTV thresholds and DTI ratio thresholds.[52] We compared the percentage of mortgages (prime, near-prime, and subprime combined) originated in 2006 and 2010 with LTV ratios of 80 percent or less (more restrictive threshold) to the percentage of mortgages with LTV ratios of 90 percent or less (less restrictive threshold) (see fig. 6). We made similar comparisons for mortgages (prime and near-prime only) with reported DTI ratios of 36 percent or less (more restrictive) or 41 percent or less (less restrictive).[53] Our analysis showed that about 82 percent of the mortgages originated in 2010 had LTV ratios of 80 percent or less and that about 91 percent had LTV ratios of 90 percent or less. The corresponding percentages of mortgages made in 2006, just prior to the housing crisis, with restrictive and less restrictive LTV ratios were about 78 percent and about 89 percent respectively.

[52]For this analysis, we excluded government-insured mortgages, which typically have low down payments (high LTVs), because the Dodd-Frank Act exempts them from the risk retention requirement. We also applied the 80 and 90 percent LTV thresholds to all mortgage types (e.g., purchase mortgages and refinance mortgages).

[53]As in the previous section of this report, this analysis used reported DTI ratios, which may understate debt obligations or overstate income in some cases. As a result, the proportions of mortgages we show as meeting the different criteria are likely somewhat higher than they would have been if all of the DTI ratios had been calculated in a uniform and accurate manner.

Figure 6: Proportions of Prime, Near-Prime, and Subprime Mortgages Originated in 2006 and 2010 That Would Have Met Different Requirements for LTV Ratio



Source: GAO analysis of CoreLogic data.

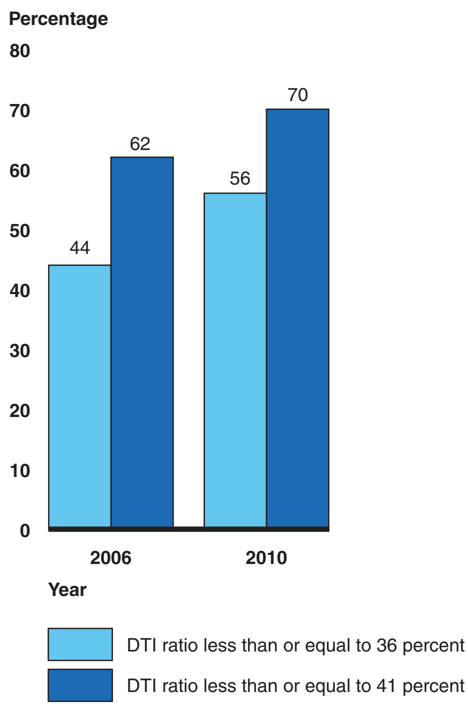
Note: For this analysis, we excluded government-insured mortgages, which typically have low down payments (high LTVs), because the Dodd-Frank Act exempts them from the risk retention requirement. For the mortgages that are included, we used the CoreLogic variable for LTV ratio, which does not take any subordinate liens into account. We did not use the variable for combined LTV ratio, which does take subordinate liens into account, because it was not reliable. As a result, the percentages we report are likely somewhat higher than they would have been if we had been able to use combined LTV ratios. The CoreLogic database we used for this analysis covers a broad cross-section of the mortgage market. However, because of limitations in the coverage and completeness of the data, our analysis may not be fully representative of the market segments shown.

Further, about 56 percent of the prime and near-prime mortgages originated in 2010 with reported DTI ratios met the more restrictive DTI threshold of 36 percent or less (see fig. 7).[54] About 70 percent of the prime and near-prime mortgages met the less restrictive DTI threshold of 41 percent or less. The corresponding percentages for mortgages originated in 2006 were about 44 percent and about 62 percent respectively. An FHFA analysis of mortgages originated in 2009 that were purchased by the enterprises illustrates the impact of simultaneously applying multiple criteria in the proposed QRM rules (including DTI and LTV thresholds, a requirement that mortgage payments pay down principal, and a requirement for full documentation).[55] FHFA estimated that only about 31 percent of these mortgages would have met the proposed QRM criteria they examined. FHFA estimated that this percentage was even lower for mortgages originated in previous years.

[54]The CoreLogic data did not contain information on DTI ratios for subprime mortgages.

[55]FHFA's analysis used the separate LTV thresholds proposed for purchase mortgages (80 percent) and different types of refinance mortgages (75 percent for no-cash-out refinances and 70 percent for cash-out refinances). In addition, FHFA used the proposed thresholds for both the DTI ratio (36 percent) and the percentage of a borrower's income that goes toward mortgage payments (28 percent). They also used a credit score threshold as a proxy for proposed criteria concerning borrower delinquency history. For a discussion of these and other proposed QRM criteria FHFA applied, see FHFA, *Mortgage Market Note 11-02* (Apr. 11, 2011), available at http://www.fhfa.gov/Default.aspx?Page=77.

Figure 7: Proportions of Prime and Near-Prime Mortgages Originated in 2006 and 2010 That Would Have Met Different Requirements for DTI Ratio



Source: GAO analysis of CoreLogic data.

Note: For this analysis, we excluded government-insured mortgages. Percentages reflect only those mortgages for which data were available. About 56 percent of the prime and near-prime mortgages from 2006 in our CoreLogic data sample and 43 percent of the 2010 mortgages lacked information on the DTI ratio. We concluded that these mortgages were likely not systematically different from mortgages with DTI information based on a comparison of the distribution of borrower credit scores associated with both groups of mortgages, which showed little difference. Additionally, the percentages shown are based on reported DTI ratios, which may understate debt obligations or overstate income in some cases. As a result, the proportions of mortgages we show as meeting the different DTI criteria are likely somewhat higher than they would have been if all of the DTI ratios had been calculated in a uniform and accurate manner. The CoreLogic database we used for this analysis covers a broad cross-section of the mortgage market. However, because of limitations in the coverage and completeness of the data, our analysis may not be fully representative of the market segments shown.

FHFA's findings suggest that relatively restrictive QRM criteria could ultimately subject a large proportion of mortgages that are not insured or guaranteed by the government to a risk retention requirement if the mortgages are securitized. Some mortgage industry and consumer representatives we spoke with expressed concern that this approach would subject some mortgages with relatively low default risks to risk retention and make mortgage credit less affordable for many borrowers, because the increased securitization costs would be passed on to borrowers in the form of higher mortgage interest rates and fees. Several also indicated that a risk retention requirement that applied to a broad segment of the market could make securitization a less attractive method for financing mortgages. Because lenders may rely on securitization (as opposed to bank deposits, for example) to provide funds for mortgage lending, actions that make securitization more costly could hamper recovery of the private-label RMBS market, according to some market participants. Additionally, a range of industry stakeholders, including lenders and consumer groups, told us that many creditworthy borrowers—particularly low- and moderate-income households—are not able to make a down payment of 20 percent and would therefore not qualify for QRMs under the proposed rules.

However, federal regulators and other industry stakeholders favored relatively restrictive QRM criteria and indicated that interest rates for non-QRMs would likely be only modestly higher than those for QRMs. For example, the Chairman of the FDIC has stated that it is appropriate for the QRM definition to be narrowly drawn because QRMs are intended to be the exception and not the rule. She said she anticipates that QRMs will account for a small part of the mortgage market and that mortgages securitized with risk retention or held in lender's portfolios will provide more flexible options for borrowers who cannot meet the QRM criteria. Further, rulemaking agencies indicated that more restrictive QRM criteria could help ensure that a sufficient volume of non-QRMs subject to risk retention would be available for an active, liquid securitization market for such mortgages. Federal regulators have also stressed that historical loan performance data show that the mortgage characteristics in the proposed QRM definition significantly influence the risk of mortgage default. For example, FHFA analyzed mortgages originated from 1997 through 2009 and purchased by the enterprises. They estimated that of the mortgages that would have met all of the other proposed QRM criteria, those with LTV ratios of 80 percent or less had 90-day delinquency rates that were 2.0 to 3.9 times lower than those with LTV ratios greater than 80 percent and less than 90 percent.[56] Finally, FDIC officials have stated that risk retention should not result in substantially higher interest rates for non-QRM borrowers—less than half a percentage point, according to their estimates—and comes with the benefit of safer

[56]Although there is no uniform definition of default across the lending industry, 90-day delinquency rates (i.e., the percentage of mortgages for which the borrower is least 90 days late on the payments) are sometimes used as an indicator of mortgage default.

and sounder lending practices.[57] They stressed that a 5 percent risk retention requirement would increase costs to borrowers only to the extent that it exceeded what investors would demand in the absence of the requirement.

Finally, the Dodd-Frank Act exempts government-insured or -guaranteed mortgages from the risk retention requirement but does not apply this exemption to mortgages backed by the enterprises.[58] However, rulemaking agencies have proposed that the full guaranty provided by the enterprises would satisfy the requirement while these institutions are in conservatorship. Some market participants told us that in the short term, this provision would limit the impact of a risk retention requirement on the availability and cost of mortgage credit because most mortgages, including many that would be non-QRMs, are currently securitized by the enterprises. However, others have argued that the proposed rules would help preserve the enterprises' dominant market position by not subjecting them to the costs associated with retaining 5 percent of the securities they issue. In contrast, FHFA has indicated that requiring the enterprises to hold 5 percent of their securities would have little impact on the enterprises' costs (because they already bear 100 percent of the credit risk) and would be inconsistent with federal efforts to reduce the mortgage assets held for investments by each enterprise.

Different Forms of Risk Retention Could Have Different Financial Implications

Several industry stakeholders we spoke with stated that different forms of risk retention could have different implications for securitizers' incentives and costs that in turn could affect mortgage borrowers differently. The proposed risk retention rules provide securitizers with a number of options for meeting the 5 percent risk retention requirement, in recognition of the different securitization structures and practices that exist for different classes of assets. Federal Reserve Board officials said that this flexibility

[57] Estimates of the impact of a risk retention requirement on borrower interest rates depend on a number of assumptions, including the form of risk retention, capital costs, and the liquidity of RMBS backed by non-QRMs. FDIC officials told us that their estimate pertains to both horizontal and vertical risk retention, assumes capital costs are not affected by the accounting consolidation scenario discussed in this section, and assumes a liquid market for RMBS backed by non-QRMs.

[58] As previously noted, the Dodd-Frank Act also does not apply the exemption for government-insured or –guaranteed mortgages to mortgages backed by Federal Home Loan Banks.

was designed to reduce the proposed rules' potential to negatively affect the availability and costs of credit. However, it is possible that investors in RMBS will demand particular forms of risk retention or amounts greater than 5 percent. Stakeholders we spoke with primarily discussed two options that illustrate the differences in the potential financial impacts of a risk retention requirement on securitizers: retention of a tranche or multiple tranches of a securitization that are the first to absorb losses ("horizontal" risk retention)—and retention of a pro rata portion of each tranche of a security ("vertical" risk retention).[59]

A number of securitization market participants and regulatory officials indicated that retaining a horizontal slice of a securitization would potentially provide greater incentives for quality loan underwriting and would carry substantially higher capital costs than vertical risk retention. Certain regulated securitizing institutions, including banks and bank holding companies, are subject to risk-based regulatory capital requirements, meaning they must hold a minimum level of capital ("capital charges") to cover their risk exposures, including assets held on their balance sheets.[60] Horizontal risk retention would require securitizers to retain an economic interest in the part of the security that absorbs losses first and carries a higher risk weight under regulatory capital

[59]The other options are L-shaped (a hybrid of the horizontal and vertical options), seller's interest (typically a shared interest with all of the investors in a security backed by a pool of revolving loans, such as credit cards), representative sample (a randomly selected representative sample of assets that is equivalent, in all material respects, to the securitized assets and is commonly used in connection with securities backed by automobile loans), and an option specifically designed for structures involving asset-backed commercial paper. To help ensure that securitizers do not reduce or offset their retained economic interest by monetizing "excess spread" (i.e., the difference between the gross yield on a pool of securitized assets minus the cost of financing those assets) generated over time, rulemaking agencies also proposed requiring securitizers to place these funds into a "premium capture cash reserve account." This account would be in addition to the base risk retention requirement and would be used to absorb the first losses.

[60]Federal banking and thrift regulators require banking institutions to maintain a minimum amount of capital and generally expect them to hold capital above these minimums, commensurate with their risk exposure, to ensure they remain solvent in the event of unexpected losses. These requirements were established under international Basel Accord frameworks.

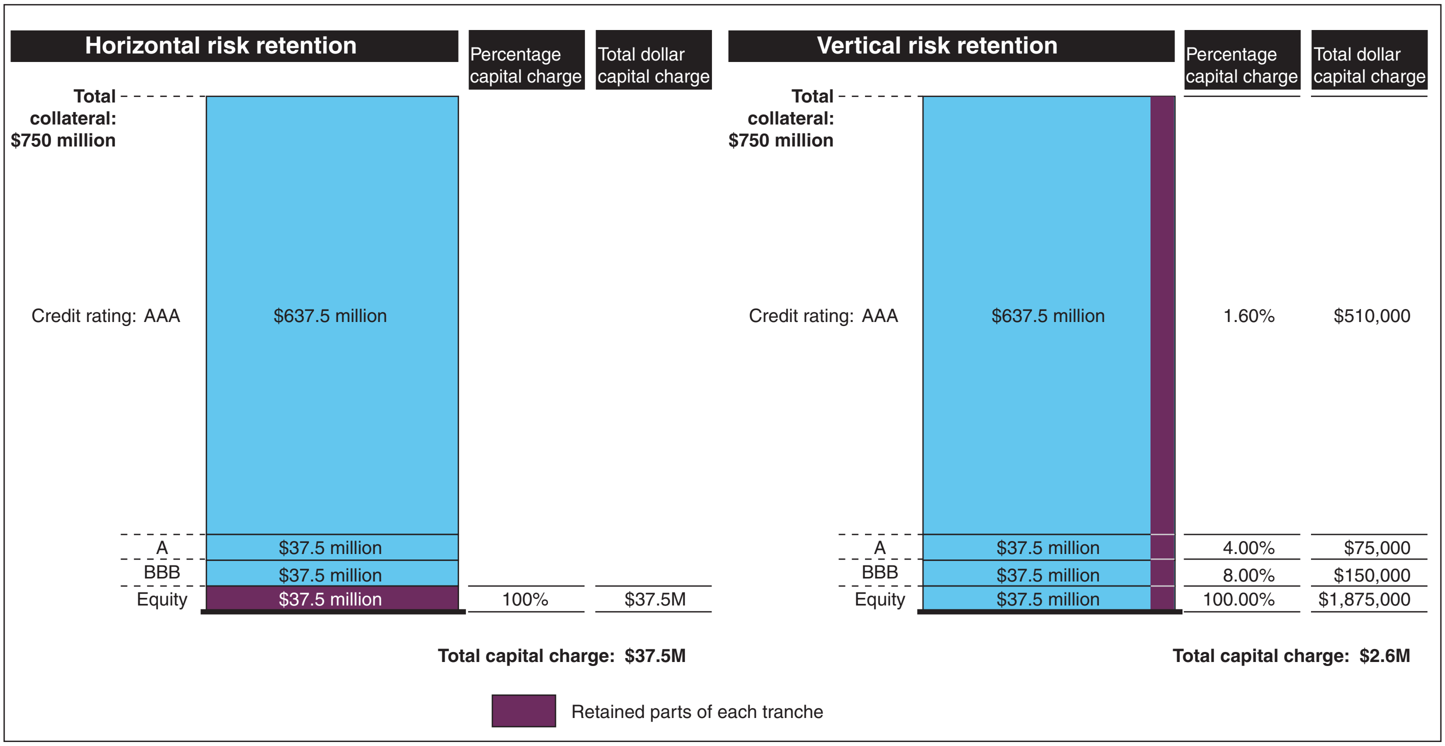
requirements.[61] One credit rating agency with which we spoke saw this approach as an advantage because the securitizers' exposure to first losses would create incentives to ensure that the mortgages backing the security were well underwritten. However, because the high risk weighting would require securitizers to hold a substantial amount of capital against the horizontal slice, these capital costs would be expected to be passed on to borrowers in the form of higher interest rates. Figure 8 illustrates the amount of capital a securitizer may have to hold—applying risk-based capital charges to each portion of a security—for a 5 percent horizontal slice of a hypothetical $750 million RMBS, compared with the corresponding amount of capital for a 5 percent vertical slice. In this example, the securitizer would have to hold $37.5 million in regulatory capital for horizontal risk retention (5 percent of $750 million—or $37.5 million—times the 100 percent capital charge for a first-loss equity tranche). With vertical risk retention, the securitizer would hold $2.6 million (the sum of the capital charges for 5 percent of each tranche of the security).[62] Because of anticipated changes in capital requirements and calculations for securitization exposures, capital charges for future RMBS may differ from this illustrative example.[63]

[61]Under regulatory capital requirements, all assets are assigned a risk weight according to the credit risk of the obligor and the nature of any qualifying collateral or guarantee, where relevant. These requirements are broadly intended to assign higher risk weights to—and require banks to hold more capital for—higher-risk assets.

[62]For example, with vertical risk retention, a securitizer would have to hold capital against 5 percent of the $37.5 million equity tranche (i.e., $37.5 million times 5 percent times a capital charge of 100 percent, which equals $1.875 million) instead of the entire $37.5 million equity tranche in the case of horizontal risk retention.

[63]For example, section 939A of the Dodd-Frank Act requires federal agencies to remove references to credit ratings, changing how capital against securitization exposures is calculated. Additionally, federal banking regulators are currently contemplating changes to regulatory capital rules, including changes related to the Basel III Accord.

Figure 8: Illustrative Example of the Implications of Horizontal and Vertical Risk Retention on Risk-Based Capital Charges



Source: GAO.

Note: We used the regulatory risk weights that federal banking regulators use to calculate the capital charges for horizontal and vertical risk retention. Because this example is meant to be illustrative, we did not apply all regulatory capital or accounting standards that could influence the capital impacts of vertical and horizontal risk retention.

Additionally, market participants indicated that interactions between horizontal risk retention and recent changes to accounting standards for securitizations could increase the cost of securitizing mortgages. Securitization typically involves the transfer of assets to an SPE that removes assets from the securitizers' balance sheets and ensures that investors still receive payments in the event of the bankruptcy or failure of the securitizers. In 2009, the Financial Accounting Standards Board issued financial accounting statement (FAS) 166, which addresses whether securitizations and other transfers of financial assets are treated as sales or financings, and FAS 167, which requires securitizers or lenders with a controlling financial interest in an SPE to "consolidate" the securitized assets on their balance sheets.[64] Although the need for accounting consolidation would depend on the specific characteristics of each securitization transaction, added on-balance sheet exposure from any consolidated assets would generally result in higher regulatory capital requirements for securitizers than if the assets were off-balance sheet. A number of securitization market stakeholders indicated that securitization could be economically unattractive in cases in which accounting consolidation was triggered.

Vertical risk retention potentially exposes the securitizer to less credit risk than horizontal risk retention because it involves retaining a portion of every tranche of a security—some of which have a relatively low risk of loss—rather than just the tranche in which credit losses are concentrated. Vertical risk retention is also considered less likely to result in accounting consolidation because it potentially represents less of a financial interest in an SPE. While the securitizer could therefore have less financial incentive to securitize higher-quality mortgages, some market participants indicated that vertical risk retention would help to align the securitizer's interest with those of investors in each tranche. Investor representatives, in particular, noted that when the securitizer held only the bottom-most (first-loss) tranche and was also the mortgage servicer, it could have an incentive to service the mortgages in ways that favored just its tranche rather than all tranche holders. For example, because lower tranches absorb initial losses, they generally benefit from actions that delay the realization of losses from mortgage defaults, which may include extending repayment periods and postponing foreclosure. In contrast, senior tranches generally benefit from actions that pay down mortgage principal as quickly as possible, which may include expeditiously foreclosing on a delinquent borrower and selling the foreclosed property. Investor representatives indicated that having securitizers hold a vertical slice of a

[64]Consolidation is the process by which the financial statements of a parent company are combined with those of its subsidiaries (in this case the SPE), as if they were a single economic entity. A securitizer would have a controlling financial interest in an SPE if it had (1) the power to direct the activities of the SPE that most significantly affected the SPE's economic performance, and (2) the obligation to absorb the losses of, or the rights to receive benefits from, the SPE that could potentially be significant to the SPE. FAS 166, Accounting for Transfers of Financial Assets, an Amendment of FASB Statement No. 140, is codified within Accounting Standards Codification (ASC) Topic 860, and FAS 167, Amendments to FASB Interpretation No. 46(R) is codified within ASC Topic 810.

security would help to ensure that mortgages were serviced equitably for all tranche holders.

The Implications of a Risk Retention Requirement Will Depend on Other Key Regulatory Decisions

Implications of a Nonuniform Requirement

The Dodd-Frank Act specifies a risk retention requirement for non-QRMs of at least 5 percent but authorizes the rulemaking agencies to create a different requirement—for example, greater than 0 and less than 5 percent—for non-QRMs that meet underwriting standards the agencies prescribe. In March 2011, the rulemaking agencies proposed a uniform 5 percent level of risk retention for securitized non-QRMs. In the proposed rule, the agencies indicated that they considered 5 percent to be a minimum level of risk retention and suggested that levels below 5 percent might not provide sufficient incentive for sound mortgage underwriting in all circumstances.

A range of mortgage and securitization industry groups told us that a nonuniform requirement would have both advantages and disadvantages, some of which have implications for the cost and availability of mortgage credit and risks to the mortgage market. On the one hand, stakeholders noted that a nonuniform requirement could, in principle, be more economically efficient than a uniform requirement because it could allow the risk retention amount to be scaled to the risk level of the mortgages being securitized. Further, some noted that a 5 percent requirement could be excessive for non-QRMs with relatively low default risk, unnecessarily raising the cost of those mortgages and tying up capital that could be used to securitize additional mortgages. As previously discussed, some mortgage industry and consumer group representatives indicated that if the final QRM criteria were highly restrictive, non-QRMs could include some lower-risk mortgages. On the other hand, industry stakeholders also stated that a nonuniform requirement could potentially be difficult to develop and enforce. To develop such a requirement, rulemaking agencies would have to divide non-QRMs into different categories based on risk level and develop an appropriate risk retention percentage for each category. Several industry analysts indicated that it would be challenging to calibrate a risk retention requirement that finely. Additionally, assessing compliance with a requirement that had multiple risk categories and retention levels could be more difficult than assessing compliance with a uniform requirement.

Drawing general conclusions about whether a uniform or a nonuniform risk retention requirement would be preferable is difficult, for two reasons. First, historical and marketwide information about the amount, form, and impact of risk retention in the secondary mortgage market is limited. Industry stakeholders told us that risk retention practices for private-label RMBS varied in terms of the slice (if any) of the security that securitizers retained and how long and for what purpose they retained it. More specifically, they described a range of risk retention practices in the years leading up to the financial crisis, including retaining 1 to 3 percent horizontal slices of near-prime and subprime RMBS and nothing of prime jumbo RMBS. They also indicated that when risk retention did occur, some securitizers held the retained piece as part of an investment strategy, while others sold it soon after issuance of the security. Analysis by FDIC of a limited sample of prime and near-prime RMBS deals from 2001 through 2007 suggests that risk retention levels in the private-label market varied considerably, ranging from less than 1 percent to over 8 percent for the deals they examined. Mortgage and securitization industry participants also indicated that a lack of systematic marketwide data on these practices had prevented analysis of how different practices affected the incentives of market participants and the quality of mortgage underwriting. Without this information, it is difficult to determine whether a particular level of retained risk would be optimal for all non-QRM mortgages or whether varying the level depending on the credit quality of the mortgages would better achieve the goals of risk retention. Given this uncertainty, the requirement may need to be adjusted once regulators have assessed how the private-label RMBS market has reacted to it. For example, if a uniform 5 percent requirement was perceived as too high for some non-QRMs and limited the availability of mortgage credit for certain borrowers, regulators might want to consider a lower risk retention requirement for those mortgages. Alternatively, if the regulation established a requirement that was lower than that dictated by investors in the market, some increase might be warranted.

Second, rulemaking agencies have not made final decisions about the QRM criteria or other aspects of the risk retention requirement, and these decisions could influence whether a uniform standard would be more appropriate. For example, a nonuniform requirement could be more appropriate if the final QRM definition were restrictive (i.e., limited to mortgages of very high credit quality), because non-QRMs would potentially include mortgages with a wide range of credit risks.

Conversely, a uniform requirement could be more appropriate if the QRM definition were less restrictive, because non-QRMs would potentially encompass a narrower range of credit risks.

Implications of Risk-Sharing for Lenders

The Dodd-Frank Act places the responsibility for retaining risk on securitizers but authorizes rulemaking agencies to require that lenders share the risk retention obligations.[65] The proposed rules do not require lenders to retain risk but would permit a securitizer to allocate a portion of its risk retention requirement to any lender that contributed at least 20 percent of the underlying assets in the pool. Additionally, the proportion of risk retained by each lender could not exceed the percentage of the securitized assets it originated, and the lender would have to hold its allocated share in the same manner (e.g., vertical or horizontal) as the securitizer.

The impact of the risk retention requirement on lenders will depend, in part, on how the risk retention requirement is shared.[66] If lenders are required to share risk (either directly by regulation or indirectly though an allocation from a securitizer), they would have to hold capital against this risk exposure.[67] Several mortgage industry representatives indicated that smaller lenders, such as independent mortgage companies and small community banks, could lack sufficient capital resources to share risk retention obligations or hold non-QRMs that were not securitized on their balance sheets.[68] A few of the mortgage and securitization market participants we spoke with said that, in contrast, large lenders had the financial capacity to share risk retention obligations with securitizers or hold non-QRMs on their balance sheets, giving these lenders an advantage over smaller lenders that could ultimately reduce competition in mortgage lending. While acknowledging some of these concerns, the

[65]For example, assuming a 5 percent overall requirement, a securitizer would only need to retain 3 percent if a lender retained the remaining 2 percent.

[66]When the lender is also the securitizer, it would retain the full amount of risk retention.

[67]In the case of banking institutions, risk-based regulatory capital requirements would apply.

[68]According to Home Mortgage Disclosure Act data, independent mortgage companies originated about 20 percent of all mortgages in 2009. Although precise figures are not available for small community banks, community banks in general have originated about 15 to 20 percent of mortgages in recent years, according to a trade association that represents these institutions.

rulemaking agencies have estimated that the proposed requirement would not have a significant impact on a substantial number of small banking institutions, at least under current market conditions. They cited data indicating that small lenders generally did not securitize mortgages themselves, did not contribute 20 percent or more of the mortgages to private-label securitizations, and primarily securitized mortgages through the enterprises. A number of market participants noted that even if lenders were not required to share risk in the manner prescribed by the Dodd-Frank Act, securitizers could be expected to take steps to transfer the cost of risk exposure by paying lenders less for the mortgages they sold or requiring additional collateral to ensure the underwriting quality of the mortgages. However, others noted that lenders would pass this cost on to borrowers and that the cost would likely be marginal.

A Risk Retention Requirement Will Complement or Interact With Other Efforts to Reform Housing Finance

Risk retention is a part of legislative and regulatory efforts to reduce undisclosed risks to the overall credit market by addressing the weaknesses in the securitization process that contributed to the housing crisis. The risk retention requirement complements other parts of the Dodd-Frank Act that are intended to improve the securitization markets, as well as existing mechanisms to encourage lenders to sell high-quality loans. For example, the Dodd-Frank Act requires issuers of asset-backed securities, including RMBS, to conduct reviews of the assets underlying the securities and disclose the nature of the reviews.[69]

The Dodd-Frank Act also requires credit rating agencies and securitizers of residential mortgages (and other assets) to publicly disclose information about representations and warranties—the assertions lenders make about a loan's underwriting standards and contractual obligations to refund the value of the loan if the assertions later prove to be untrue. Representations and warranties existed prior to the mortgage crisis, and in some cases lenders failed to repurchase loans that violated these terms because they could not afford to and subsequently went out of business. Several market participants and researchers told us that these mechanisms would be more effective if they were better monitored and enforced, possibly by using third parties to verify loan information or requiring that originators demonstrate the financial ability to honor

[69]Dodd-Frank Act, sec. 945 (codified at 15 U.S.C. sec. 77g(d)). The SEC issued regulations implementing this requirement in January 2011. See 76 Fed. Reg. 4231 (Jan. 25, 2011).

warranties and repurchase requests. The Dodd-Frank Act requires credit rating agencies to disclose the representations, warranties, and enforcements available to investors when the agency issues a credit rating.[70] Securitizers are required to disclose fulfilled and unfulfilled repurchase requests so that investors can identify lenders' records related to such requests. In addition, a trade association representing the securitization industry has an ongoing effort to make representations and warranties for RMBS more standardized and transparent.

The risk retention requirement will also interact with efforts to reduce the federal government's role in mortgage finance, which could have implications for mortgage borrowers and the private-label RMBS market. Mortgages backed by the enterprises and FHA currently dominate the mortgage market, and the private-label RMBS market is largely dormant. However, the administration and Congress are considering options that would diminish the federal role and help transition to a more privatized market by winding down the enterprises and reducing the size of FHA.[71] Several mortgage market participants indicated that in the long run, if the enterprises were eliminated or their activities scaled back, more non-QRMs would be subject to risk retention, potentially raising the cost of these mortgages for borrowers. Potential changes in FHA's role also could influence how a risk retention requirement would affect mortgage borrowers. In addition to non-QRMs, FHA-insured mortgages, which are exempt from risk retention, are a potential alternative for borrowers who may not qualify for mortgages that do not meet the QRM criteria. FHA borrowers often make down payments that are low (generally less than 5 percent) compared with the 20 percent that has been proposed as the QRM down payment requirement for home purchase mortgages.[72] However, in recent years, FHA has tightened its underwriting standards and raised insurance premiums as it tries to reduce its market share and strengthen its financial condition. For example, beginning in 2010 FHA began requiring borrowers with lower credit scores to make larger down payments. Additionally, FHA is considering further steps, such as

[70]SEC issued implementing regulations for Section 943 in January 2011. See 76 Fed. Reg. 4489 (Jan. 26, 2011).

[71]Department of the Treasury and Department of Housing and Urban Development, *Reforming America's Housing Finance Market: A Report to Congress* (February 2011).

[72]FHA requires a minimum borrower contribution of 3.5 percent of the sales price of the home.

increasing down payment requirements more broadly. As a result, FHA may not provide mortgage alternatives for as many non-QRM borrowers as it would have in the past.

While Housing Counseling and High-Cost Lending Provisions May Enhance Borrower Protections, Specific Impacts Are Unknown

HUD has initiated plans to establish an Office of Housing Counseling, as required under the Dodd-Frank Act.[73] HUD already performs a number of activities that are consistent with the new office's authorized functions and plans to move these functions into the new office. Industry and consumer groups we spoke with identified opportunities for the counseling office to enhance HUD's role in housing counseling, but the financial resources for the office are uncertain. Findings from the limited research available on housing counseling are mixed, with some studies suggesting that some types of counseling can improve mortgage outcomes and others finding no effect. The Dodd-Frank Act supports another consumer protection by changing the definition of high-cost loans under HOEPA. This change could prevent some high-cost lending, although whether the definition would affect mortgages currently available to consumers is unclear.

HUD Is Creating a New Office for Its Housing Counseling Activities, but Funding Is Uncertain

To enhance consumer protections for homebuyers and tenants, the Dodd-Frank Act requires HUD to establish an Office of Housing Counseling. This office will perform a number of functions related to homeownership and rental housing counseling, including establishing housing counseling requirements, standards, and performance measures; certifying individual housing counselors; conducting housing counseling research; and performing public outreach. The office is also mandated to continue HUD's role in providing financial assistance to HUD-approved counseling agencies in order to encourage successful counseling programs and ensure that counseling is available in underserved areas.

Currently, HUD's housing counseling program operates out of the Program Support Division within the Office of Single-Family Housing.[74] HUD supports housing counseling through the division in two ways. First, it approves and monitors housing counseling agencies that meet HUD

[73]Dodd-Frank Act, sec. 1442 (codified at 42 U.S.C. sec. 3533(g)).

[74]The Program Support Division has staff in HUD headquarters and in HUD's four homeownership centers located in Atlanta, Georgia; Denver, Colorado; Philadelphia, Pennsylvania; and Santa Ana, California.

criteria and makes information about these agencies available to consumers on HUD's Web site. According to HUD officials, as of May 2011, about 2,700 counseling agencies were HUD-approved. Second, HUD annually awards competitive grants to approved agencies to help them carry out their counseling efforts. HUD's housing counseling program provides funding for the full spectrum of housing counseling, including prepurchase counseling, foreclosure mitigation counseling, rental housing counseling, reverse mortgage counseling for seniors, and homeless assistance counseling. HUD-approved agencies report to HUD on the type the number and type of service interactions (e.g., counseling sessions) they have with clients. Self-reported data on homeownership counseling conducted by these agencies indicate that service interactions for foreclosure mitigation counseling rose from about 171,000 in 2006 to more than 1.4 million in 2010, while service interactions for prepurchase counseling declined from about 372,000 to about 245,000 over the same period.[75]

Besides these two main functions, the Program Support Division and other HUD staff perform other counseling-related activities, some of which are similar to the functions the Dodd-Frank Act requires of the new counseling office. For example, HUD has developed standards and protocols for reverse mortgage counseling, certifies individual reverse mortgage counselors, is conducting research on the impact of homeownership counseling, and recently launched a public awareness campaign on loan modification scams.

A working group within HUD is in the process of developing a plan for the new counseling office. According to HUD officials, the primary change needed to create the new office is the reassignment of the approximately 190 staff who spend most of their time on housing counseling activities but also have other responsibilities. HUD expects the new office to consist of approximately 160 full-time staff members. In order to move forward with the establishment of the office and the appointment of a Director of Housing Counseling, HUD must submit a plan to Congress for approval.

[75]Counseling agencies may have multiple service interactions with the same client. Some of the HUD-approved counseling agencies that report service interaction data do not receive HUD funds, and those that do receive HUD grants also rely on other funding sources, according to HUD officials. As a result, the service interaction data do not represent just the counseling services provided with HUD funds.

HUD officials told us that the new counseling office would have advantages over their current organizational structure. They indicated that having dedicated resources, staff, and leadership would raise the profile of the housing counseling function and help the agency build a more robust capacity in this area. One official noted that getting sufficient information technology resources for housing counseling had been difficult and said that a separate counseling office might be able to compete more effectively with other parts of the agency for these resources. HUD officials also indicated that the new office would be organized to help the agency better anticipate and respond to changing counseling needs and improve interaction with counseling industry stakeholders. For example, the officials said that the new office would be organized around functional areas such as policy, training, and oversight, making it easier for industry stakeholders to direct their questions or concerns to the appropriate HUD staff. Additionally, HUD officials told us that the office would work with the CFPB's Office of Financial Literacy in the future to coordinate the housing counseling activities of both organizations.

Mortgage industry participants, consumer groups, and housing researchers we spoke with were supportive of the new housing counseling office and believed that it offered opportunities to enhance HUD's role in the housing counseling industry. For example, some of the consumer groups stated that the office could help standardize counseling practices and publicize best practices, further elevating and professionalizing the counseling industry. In addition, representatives from several of the consumer groups and researchers we met with stated that the office could help enhance coordination among counseling agencies by providing opportunities for improved training, networking, and communication. Furthermore, they said that the office could potentially support improved data collection for research on the impact of housing counseling.

Budget constraints could delay the establishment of the new counseling office and reduce the scale of HUD's housing counseling activities. Although the Dodd-Frank Act authorized $45 million per year for fiscal years 2009 through 2012 for the operations of the new office, HUD had not received any appropriations for this purpose as of May 2011. In addition, appropriations for fiscal year 2011 eliminated HUD's housing counseling assistance funds, which are primarily grant funds for approved counseling agencies.[76] According to a HUD official, as a result of this funding reduction, HUD is revising its proposal for the new counseling office and is unable to estimate when it will submit the proposal to Congress. HUD officials said they would begin the awards process for about $10 million in unspent fiscal year 2010 counseling assistance funds in May 2011 but expressed concern that some counseling agencies would run out of funds soon and might not receive additional HUD funding until well into fiscal year 2012. Housing counseling groups we spoke with said that the cuts in HUD funding, which they use to leverage private funds, ultimately could result in fewer counseling services for prospective and existing homeowners unless private funds make up the difference.[77]

Findings from the Limited Research Available on Homeownership Counseling Are Mixed

Empirical research on outcomes for homeownership counseling is limited, with some studies suggesting that foreclosure mitigation counseling can be effective in improving mortgage outcomes (e.g., remaining current on mortgage payments versus defaulting or losing the home to foreclosure).[78] However, findings on prepurchase counseling are less clear. Considered to be one element of financial literacy, these types of homeownership counseling are based on the idea that providing information and advice can help consumers make better decisions about home purchases and maintenance and work more successfully with lenders and mortgage servicers to obtain loan modifications or refinancing.

[76] In fiscal year 2010, HUD was appropriated $88 million for housing counseling assistance. The President's budget for fiscal year 2012 requests $88 million for HUD housing counseling assistance.

[77] The federal government funds homeownership counseling through a number of programs and has provided targeted support for foreclosure mitigation counseling in recent years. For example, Congress appropriated $65 million in fiscal year 2011 to the National Foreclosure Mitigation Counseling (NFMC) Program, which was designed to rapidly expand the availability of foreclosure mitigation counseling. NFMC is administered by NeighborWorks®, a government-chartered, nonprofit corporation with a national network of affiliated organizations. NeighborWorks® competitively distributes NFMC funds to three types of authorized recipients: HUD-approved counseling intermediaries (i.e., organizations that channel HUD counseling funds to local, affiliated counseling agencies), state housing finance agencies, and NeighborWorks® affiliates.

[78] Section 1013(d)(7) of the Dodd-Frank Act requires us to conduct a study on financial literacy programs. As part of this work, we are conducting a literature review of financial literacy programs.

Conducting research on homeownership counseling outcomes is challenging for a variety of reasons, and limitations in the methodologies used in existing studies make it hard to generalize the results. According to housing counseling researchers we spoke with, the primary barrier in the study of housing counseling is a lack of data. Long-term data on counseling outcomes are limited because of the difficulty of tracking counseling recipients after the counseling ends. In addition, many counseling agencies are hesitant to request sensitive personal information from clients. One researcher we spoke with told us that the ability to track loan performance over time is critical to an effective assessment of housing counseling programs. For this reason, some counseling researchers have begun working with lenders and mortgage servicers to access information on the payment status (e.g., current or delinquent) of counseling recipients and the long-term outcomes of their mortgages.

Another limitation of the current research is the lack of experimental research design, which is considered the best approach for evaluating differences in an intervention such as counseling and comparing it to no intervention.[79] Studies that employ experimental designs are often difficult and costly to conduct. We did not identify any published studies that evaluated homeownership counseling using an experimental design. Further, researchers have not been able to overcome another inherent limitation: the fact that consumers choose counseling themselves, generally voluntarily, and those who choose counseling may differ in unknown ways from those who do not.[80] Both of these issues make researchers hesitant to draw firm conclusions from the published literature. Finally, differences among counseling programs—in terms of curriculum, intervention method (e.g., one-on-one, telephone, classroom), level of intervention (e.g., intensity or amount of time spent counseling), and outcome measures—also make it difficult to draw general conclusions about the impact of housing counseling. A selected

[79]Experimental design involves random assignment of subjects to treatment and control groups to isolate the impact of the treatment. In the context of prepurchase homeownership counseling, one group of prospective homebuyers would receive counseling (treatment group) and the other would not (control group).

[80]Individuals who receive housing counseling, either on their own or by enrolling in a research study, represent a “self-selected” population. As noted, they may be systematically different than individuals who do not seek counseling, and this potential bias makes generalizing research results for the self-selected population problematic.

bibliography of research we reviewed on outcomes for prepurchase and foreclosure mitigation counseling appears at the end of this report.

The limited body of evidence available is not conclusive on the impact of all types of housing counseling. However, recent research on foreclosure mitigation counseling suggests that it can help struggling mortgage borrowers avoid foreclosure and prevent them from lapsing back into default, especially if counseling occurs early in the foreclosure process. A 2010 evaluation of the National Foreclosure Mitigation Counseling (NFMC) Program found that homeowners who received counseling under the program were more likely to receive loan modifications and remain current after counseling, compared with a group of non-NFMC borrowers with similar observable characteristics.[81] Specifically, the authors estimated that borrowers who received NFMC counseling were 1.7 times more likely to "cure" their foreclosure (i.e., be removed from the foreclosure process by their mortgage servicer) than borrowers who did not receive NFMC counseling. The authors also estimated that loan modifications received by NFMC clients in the first 2 years of the program resulted in monthly mortgage payments of $267 less on average than what they would have paid without the help of the program. Additionally, the study found that for borrowers counseled in 2008, the relative odds of bringing their mortgages current were an estimated 53 percent higher if they received counseling prior to receiving a loan modification than if they did not receive NFMC counseling. Other studies of foreclosure prevention counseling have also found that the timing of the counseling was critical and that the earlier in the foreclosure process borrowers received counseling, the more likely they were to have a positive outcome.[82]

The findings on prepurchase counseling are less clear. For example, a 2001 study analyzed data on the performance of about 40,000 mortgages made under a Freddie Mac program for low- to moderate-income

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[81]Neil S. Mayer, Peter A. Tatian, Kenneth, Temkin, and Charles A. Calhoun, *National Foreclosure Mitigation Counseling Program Evaluation: Preliminary Analysis of Program Efforts, September 2010 Update,* prepared for NeighborWorks America (Washington, D.C.: Urban Institute, 2010). The study focused on the approximately 800,000 borrowers who received NFMC counseling from January 2008 through December 2009 and a comparison sample of non-NFMC-counseled homeowners.

[82]Lei Ding, Roberto G. Quercia, and Janneke Ratcliffe, "Post-purchase Counseling and Default Resolution among Low- and Moderate- Income Borrowers," *Journal of Real Estate Research,* vol. 30, no. 3 (2008).

homebuyers, a large majority of whom received prepurchase counseling.[83] The authors compared the loan performance of program participants who received different types of prepurchase counseling to the loan performance of participants who did not. The study found that borrowers who underwent individual and classroom counseling were 34 and 26 percent less likely, respectively, to become 90 days delinquent on their mortgages than similar borrowers who did not undergo counseling.[84] However, subsequent studies have found either no effect on loan performance or effects that were potentially attributable to other factors. For example, a 2008 study of about 2,700 mortgage borrowers found that prepurchase counseling had no effect on a borrower's propensity to default.[85] A 2009 study examined a legislated pilot program in 10 Illinois ZIP codes that mandated prepurchase counseling for mortgage applicants whose credit scores were relatively low or who chose higher-risk mortgage products such as interest-only loans. Although the authors found that mortgage default rates for the counseled low-credit score borrowers were lower than those for a comparison group, the authors attributed this result primarily to lenders tightening their screening of borrowers in response to stricter regulatory oversight.[86]

Additional empirical research on the impact of housing counseling is under way at HUD and Fannie Mae. HUD's Office of Policy Development and Research issued a broad overview of the housing counseling industry in 2008 and is currently conducting two studies on mortgage outcomes related to foreclosure mitigation and prepurchase counseling programs.[87]

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[83]Abdighani Hirad and Peter M. Zorn, *A Little Knowledge is a Good Thing: Empirical Evidence of the Effectiveness of Pre-Purchase Homeownership Counseling,* Joint Center for Housing Studies of Harvard University, Low Income Homeownership Working Paper Series 01.4 (Cambridge, Mass.: August 2001).

[84]Hirad and Zorn, *A Little Knowledge Is a Good Thing.*

[85]Roberto Quercia and Jonathan S. Spader, "Does Homeownership Counseling Affect the Prepayment and Default Behavior of Affordable Mortgage Borrowers?" *Journal of Policy Analysis and Management*, vol. 27, no. 2 (2008).

[86]Sumit Agarwal, Gene Amromin, Itzhak Ben-David, Souphala Chomsisengphet, and Douglas D. Evanoff, *Do Financial Counseling Mandates Improve Mortgage Choice and Performance? Evidence from a Legislative Experiment*, working paper 2009-07 (Federal Reserve Board of Chicago, 2009).

[87]Christopher E. Herbert, Jennifer Turnham, and Christopher N. Rodger, *The State of the Housing Counseling Industry*, Abt Associates for the U.S. Department of Housing and Urban Development (Washington, D.C.: September 2008).

The foreclosure mitigation study will follow 880 individuals and evaluate mortgage outcomes 12 months after counseling ends. HUD officials said that they expected the study to be published in 2012. The prepurchase counseling study will use an experimental design and will track 1,500 to 2,000 individuals who receive different types of counseling (one-on-one, group, Internet, or telephone) or no counseling. HUD officials said they expected data collection for this study to begin in 2012. In addition, Fannie Mae is conducting both prepurchase and postpurchase counseling studies. According to Fannie Mae officials, the prepurchase study will track over a 2-year period the loan performance of borrowers who received counseling prior to purchasing a home. The postpurchase study will evaluate the impact of telephone counseling on existing homeowners who receive loan modifications through the Department of the Treasury's Home Affordable Modification Program.[88]

Expanded HOEPA Provisions Could Protect Homebuyers by Providing Additional Restrictions For High-Cost Lending

As previously noted, HOEPA regulates and restricts the terms and characteristics of mortgages that exceed specified APR and fee triggers. For these "high-cost loans," HOEPA requires enhanced preclosing disclosures to borrowers, restricts certain loan contract terms, and imposes penalties on lenders for noncompliance. In addition, HOEPA imposes liabilities on purchasers or securitizers ("assignees") of high-cost loans for violations of law committed by the mortgage originators.[89] Because of the associated penalties and liabilities, lenders have generally avoided making high-cost loans, and the secondary market for these loans has been negligible. Data collected under the Home Mortgage Disclosure Act (HMDA) indicate that in 2004 (the first year for which marketwide data on high-cost loans are available), lenders reported making 23,000 high-cost loans, which accounted for only 0.003 percent of all the originations of home-secured refinance or home improvement

[88]The purpose of the Home Affordable Modification Program is to enable borrowers who meet eligibility requirements to avoid foreclosure by modifying loans to a level that borrowers can afford and sustain in the long-term.

[89]Assignee liability is intended to discourage secondary market participants from purchasing loans that may have predatory features and to provide an additional source of redress for victims of abusive lenders.

loans reported for that year.[90] The number of reported high-cost loans rose to about 36,000 in 2005 but fell every year thereafter. In 2009, the most current year for which HMDA data are available, these loans numbered only 6,500, which, in aggregate, made up less than 0.1 percent of all the originations of home-secured refinancing and home improvement loans reported for that year.

The Dodd-Frank Act expanded the definition of high-cost mortgages in several ways. Prior to the Dodd-Frank Act, the definition of such loans applied only to refinance loans and closed-end home equity loans (e.g., home improvement loans) secured by the borrower's principal dwelling.

However, the Dodd-Frank Act expanded the definition of high-cost mortgages by

- Applying the high-cost triggers to a wider range of loan types, including mortgages for purchasing a home, open-end loans, and any other home-secured loan other than a reverse mortgage.

- Lowering the APR trigger from 8 percentage points to 6.5 percentage points over the average prime offer rate for first liens, and from 10 percentage points to 8.5 percentage points over the average prime offer rate for subordinate liens.[91]

- Lowering the points and fees trigger from 8 percent to 5 percent of the total loan amount and banning the financing of points and fees.[92]

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[90]HMDA requires lending institutions to collect and publicly disclose information about housing loans and applications for such loans. HMDA data traditionally capture about 80 percent of the mortgages funded each year and are one of the most comprehensive sources of information on mortgage lending. Some high-cost loans are extended by institutions not covered by HMDA, and some high-cost loans made by HMDA-covered institutions are not required to be reported.

[91]The Dodd Frank Act also amended the APR trigger to be based upon the average prime offer rate, to be published monthly by the Federal Reserve Board, rather than the yield on Treasury securities having comparable periods of maturity.

[92]The Dodd-Frank Act also expanded the definition of points and fees to include all compensation paid by the consumer or creditor directly or indirectly to the mortgage originator.

- Adding a third trigger for prepayment penalties extending beyond 36 months from mortgage closing or exceeding 2 percent of the outstanding balance of the mortgage.

In addition, the Dodd-Frank Act prohibits prepayment penalties for high-cost loans and requires that borrowers undergo counseling with a HUD-approved counselor before taking out a high-cost loan.

Data limitations make assessing the potential impact of the new definition difficult, but the views of industry stakeholders and prior research provide some useful perspectives. Additional information would be needed to assess the extent to which the new definition would affect mortgages currently available to consumers. As we have previously reported, marketwide data on APRs, points, and fees are not readily available to researchers.[93] As a result, determining the proportion of mortgages made in recent years that might have met the new high-cost triggers is difficult. Industry stakeholders we spoke with indicated that the new definition of high-cost loans would further expand disincentives for originating mortgages with potentially predatory terms and conditions. Additionally, they said that lenders would likely continue to avoid offering high-cost loans because the strict penalties and liabilities attached to these loans make them risky to originate and difficult to securitize. In prior work, we examined research on the impact of state and local anti-predatory lending laws—some of which are similar to HOEPA—on subprime mortgage markets. This research provides some evidence that anti-predatory lending laws can have the intended effect of reducing loans with problematic features without substantially affecting credit availability.[94]

Implementing mortgage-related provisions in the Dodd-Frank Act will involve tradeoffs between providing consumer protection and maintaining credit availability. Additionally, potential interactions with plans to scale back government involvement in the mortgage market and expand the role of private capital add complexity to implementation efforts. Limited data and research show that certain provisions could provide benefits to homebuyers and the larger mortgage market. However, the ultimate impact of the Dodd-Frank Act's mortgage-related requirements is not yet known and will depend, in part, on regulatory actions, decisions to fund

[93]GAO-10-805.

[94]GAO-09-741.

housing counseling, and mortgage market adjustments that have not yet occurred.

Agency Comments and Our Evaluation

We provided a draft of this report to the Federal Reserve Board, FDIC, FHFA, OCC, OTS, NCUA, HUD, and SEC for their review and comment. We received written comments from the Chairman of the NCUA that are reprinted in appendix III. We also received technical comments from the Federal Reserve Board, FDIC, FHFA, HUD, OCC, and SEC, which we incorporated as appropriate. OTS did not provide comments on the draft report.

In its written comments, NCUA indicated, as we do, that the impact of the Dodd-Frank Act would depend on regulatory decisions that had yet to be made. NCUA also said that while our report found that most mortgages would have met individual QM criteria, applying the criteria simultaneously would narrow the population of loans that would qualify as QMs. While this is a reasonable conclusion, as stated in our report, we were unable to determine the proportion of mortgages meeting all of the QM criteria we examined because of limitations in the data (e.g., missing or unreliable values) available for our analysis. We added language to the report to clarify the impact of these limitations on our analysis.

With respect to rulemaking efforts, NCUA expressed concern about the lack of a mechanism for non-QMs to receive QM status after some period of performance given the potential difficulty some borrowers, including those of modest means, may have in meeting the QM criteria. NCUA suggested that creating such a mechanism could help achieve the goal of protecting borrowers from unsustainable mortgage products while maintaining broad access to mortgage credit.

We are sending copies of this report to the appropriate congressional committees, the Chairman of FDIC, the Chairman of the Federal Reserve Board, the Acting Director of FHFA, the Secretary of Housing and Urban Development, the Chairman of NCUA, the Acting Comptroller of the Currency, the Chairman of SEC, the Acting Director of OTS, the Bureau of Consumer Financial Protection, and other interested parties. In addition, the report is available at no charge on the GAO Web site at http://www.gao.gov.

If you or your staffs have any questions about this report, please contact me at (202) 512-8678 or shearw@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report are listed in appendix IV.

William B. Shear

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Appendix I: Objectives, Scope, and Methodology

Our objectives were to (1) assess the proportions of mortgages originated from 2001 through 2010 that would have met selected qualified mortgage (QM) criteria specified in the Dodd-Frank Wall Street Reform and Consumer Protection (Dodd-Frank Act) and describes the views of mortgage industry stakeholders on the potential effects of the QM criteria on the mortgage market, (2) discuss relevant information and the views of mortgage industry stakeholder on the potential impact of a risk retention requirement on the mortgage market and discuss the advantages and disadvantages of a uniform risk retention requirement, and (3) describe what research and the views of mortgage industry stakeholders suggest about the potential impact of provisions in the Dodd-Frank Act regarding homeownership counseling and changes to the Home Ownership Equity Protection Act (HOEPA).

Assessment of Qualified Mortgage Criteria

To assess the proportions of recent loans that would likely have met selected QM criteria, we reviewed relevant statutory provisions and proposed rules to implement those provisions. We applied the QM criteria to mortgages in a proprietary loan-level servicing database from CoreLogic, Inc. This database contains information from major mortgage servicers and covers a broad cross-section of the mortgage market. For example, CoreLogic estimates that for the period we examined, the database captures 60 to 65 percent of the mortgages purchased by Fannie Mae and Freddie Mac (the enterprises), approximately 50 percent of subprime mortgages, and about 90 percent of mortgages with government insurance or guarantees. Nevertheless, because of limitations in the coverage and completeness of the data, our analysis may not be fully representative of the mortgage market as whole. For our analysis, we used a random 10 percent sample of the database that amounted to about 6.6 million mortgages for the 2001 through 2010 period. Our sample included purchase and refinance mortgages and mortgages to owner-occupants and investors, and excluded second-lien mortgages. We assessed the reliability of the CoreLogic data by interviewing CoreLogic representatives about the methods the firm used to collect and ensure the integrity of the information. We also reviewed supporting documentation about the database. In addition, we conducted reasonableness checks on the data to identify any missing, erroneous, or outlying figures. We concluded that the data elements we used in this objective and the following objective were sufficiently reliable for our purposes.

We focused on mortgages originated from 2001 through 2010 to provide insight into the potential effects of the Dodd-Frank Act's provisions under different market conditions and lending environments. We applied each QM criterion separately, calculating the proportion of mortgages in each annual loan origination cohort that likely would have met the criterion. We were unable to determine the proportion of mortgages that would have met all of the criteria we examined due to the number of records in the database that had missing or unreliable values for one or more of the criteria. For example, the database contained no information on DTI ratio for subprime mortgages and did not have reliable information on documentation of borrower income and assets. As a result, we determined that applying the criteria simultaneously would not have produced reliable results. Because the CoreLogic data group mortgages into two broad categories—one containing prime, near-prime, and government-insured loans and another containing subprime loans—we examined these categories separately when possible.

The data did not contain information needed to examine all of the QM criteria specified in the Dodd-Frank Act. As a result, our analysis focused on five of the nine QM criteria specified in the Dodd-Frank Act for which sufficient data, including data from the CoreLogic database, were available. These criteria were

- regular periodic payments do not result in an increase in the principal balance or result in a deferral of the repayment of principal;
- the loan term does not exceed 30 years;
- except for balloon loans under specified circumstances, the mortgage does not include balloon payments;
- borrower income and financial resources are verified and documented; and
- the loan complies with guidelines or regulations established by the Board of Governors of the Federal Reserve System (Federal Reserve Board) relating to ratios of total monthly debt to monthly income (e.g., debt service-to income (DTI) ratio).

In general, for each year from 2001 through 2010, we identified the proportion of mortgage originations that would have met the individual criteria. We were not able to calculate relevant proportions for certain years and mortgage market segments due to data limitations. For example, because few subprime mortgages were originated after 2007, we only present data for 2001 through 2007 for that market segment.

Regarding the criterion for repayment of principal, our analysis focused on mortgages with negative amortization features. Our analysis does not account for interest-only mortgages because most loan records in the CoreLogic data had missing values for the interest-only indicator. The Dodd-Frank Act does not contain a specific threshold for DTI ratio and leaves that decision to rulemakers. For illustrative purposes, we used the 41 percent ratio that is used as a guideline for underwriting mortgages insured by the Federal Housing Administration (FHA). The CoreLogic database did not contain information on DTI for any subprime mortgages, nor for many prime, near-prime, and government-insured mortgages. Because DTI information was missing for the large majority of mortgages originated in 2001 and 2002, we only present DTI data for 2003 through 2010. For the latter period, about 53 percent of the mortgages in the CoreLogic data sample did not have DTI information. We concluded that those mortgages were likely not systematically different from mortgages with DTI information based on a comparison of the distribution of borrower credit scores associated with both groups of mortgages, which showed little difference. Additionally, our analysis was based on reported DTI ratios, which may understate debt obligations or overstate income in some cases. As a result, the proportions of mortgages we show as meeting the criterion are likely somewhat higher than they would have been if all of the DTI ratios had been calculated in a uniform and accurate manner. To examine the subprime market segment, we drew upon information from a prior analysis we conducted of mortgage characteristics using a separate CoreLogic database that captures a large majority of subprime mortgages.[1] We also examined a fifth QM criterion in the Dodd-Frank Act—documentation of borrower income and assets—using information from that prior analysis, data from the Federal Housing Finance Agency (FHFA) on mortgages purchased by the enterprises, and information on FHA policies concerning borrower documentation. (Although the CoreLogic database contained information on documentation level, we determined that it was not sufficiently reliable for our purposes.) For certain QM criteria (repayment of principal, loan term, balloon payment, and DTI ratio), we performed a similar analysis by geographic groupings based on racial, ethnic, income, and house price patterns. Appendix II contains the results and methodology for this analysis. Data limitations prevented us from assessing three of the

[1] GAO-09-848R. For that report, we used CoreLogic's Asset-backed Securities database, which contains information on securitized subprime and near-prime mortgages.

remaining four QM criteria contained in the Dodd-Frank Act— specifically, those relating to interest rates used for underwriting adjustable-rate mortgages, consideration of applicable taxes and insurance in underwriting, and limitations on points and fees. We were not able to examine the fourth criterion concerning reverse mortgages because the Federal Reserve Board did not establish QM standards for them. In proposed regulations, the Federal Reserve Board indicated that QM requirements were not relevant to reverse mortgages because the Dodd-Frank Act does not subject reverse mortgages to the ability-to-repay requirement.

To obtain additional information and views on the potential effects of the QM criteria specified in the Dodd-Frank Act, we reviewed relevant research literature and conducted interviews with nearly 40 individual mortgage and securitization industry stakeholders. These stakeholders included representatives from financial services companies (major mortgage lenders and mortgage securitizers); groups representing mortgage lenders, brokers, securitizers, and investors; groups representing consumer interests; and academics. Additionally, we interviewed officials from the Federal Reserve Board, Office of the Comptroller of the Currency (OCC), Federal Deposit Insurance Corporation (FDIC), Office of Thrift Supervision (OTS), National Credit Union Administration (NCUA), Department of Housing and Urban Development (HUD), and FHFA. We also reviewed testimonies and published papers from these stakeholders that documented their views.

Assessment of Risk Retention Requirement

To assess the potential impact of the Dodd-Frank Act's risk retention requirement on the mortgage market, we reviewed relevant statutory provisions and proposed rules to implement those provisions. We also reviewed available information on mortgage securitization practices prior to the financial crisis and factors that may affect the impact of the risk retention requirement, including information from two other studies on risk retention required by the Dodd-Frank Act from the Federal Reserve Board and the Financial Stability Oversight Council. To assess the implications of interactions between the risk retention requirement and other mortgage market and securitization reforms, we reviewed other provisions in the Dodd-Frank Act intended to improve the securitization process and information on proposed changes to the federal government's role in housing finance.

Because the risk retention regulations were being developed during the course of our audit work, we interviewed the key private sector mortgage and securitization industry stakeholders mentioned previously as well as representatives from two credit rating agencies to obtain views on the potential impact of a risk retention requirement. We obtained their views on how regulatory decisions regarding the form and coverage of the requirement may affect the availability and cost of mortgage credit for borrowers and the viability of a private-label residential mortgage-backed securities (RMBS) market. Additionally, we interviewed officials from the previously cited federal agencies and the Securities and Exchange Commission (SEC) and reviewed their research, testimonies, and other public statements on risk retention. We also reviewed comment letters, testimonies, and published papers from these stakeholders that documented their views.

To illustrate the potential impact of regulatory decisions regarding the coverage of the risk retention requirement, we used the CoreLogic data to examine selected criteria (loan-to-value (LTV) ratio and DTI ratio) being considered by regulators as part of the qualified residential mortgage (QRM) rulemaking. We included only conventional mortgages in the analysis because mortgages that are insured or guaranteed by the federal government are exempt from the risk retention requirement. We analyzed the data to describe the proportions of mortgages that may have met more restrictive and less restrictive versions of these criteria in 2006 (a period of relatively lax underwriting standards) and 2010 (a period of relatively stringent underwriting standards).[2] For the LTV analysis, we used 80 percent as the more restrictive criterion (based on proposed QRM rules for purchase mortgages) and 90 percent as the less restrictive criterion. We used the CoreLogic variable for LTV ratio, which does not take any subordinate liens into account. We did not use the variable for combined LTV ratio, which does take subordinate liens into account, because it was not reliable. As a result, the percentages we report are likely somewhat higher than they would have been if we had been able to use combined LTV ratios. For the DTI analysis, we used 36 percent as the more restrictive criterion (based on proposed QRM rules) and 41 percent as the less restrictive criterion. We limited the analysis of DTI ratios to prime and near-prime mortgages because the CoreLogic database did not contain DTI ratios for subprime mortgages. As in the DTI analysis in the previous section of the report, we used reported DTI ratios

[2]The LTV ratio is the amount of the loan divided by the value of the home at mortgage origination.

in the CoreLogic database, which may understate debt obligations or overstate income in some cases. As a result, the proportions of mortgages we show as meeting the different DTI criteria are likely somewhat higher than they would have been if all of the DTI ratios had been calculated in a uniform and accurate manner. To provide additional perspective on the potential coverage of the risk retention requirement, we reviewed an analysis by FHFA, which examined the proportion of mortgages purchased by the enterprises that would have met the proposed QRM criteria, including those for LTV and DTI ratios.

To assess the financial impact of the risk retention requirement on lenders and securitizers, we reviewed relevant accounting standards and federal risk-based regulatory capital requirements that may interact with risk retention. In particular, we reviewed financial accounting statement (FAS) 166 (which addresses whether securitizations and other transfers of financial assets are treated as sales or financings), FAS 167 (which requires securitizers or lenders with a controlling financial interest in an SPE to “consolidate” the securitized assets on their balance sheets), and regulatory capital standards based on the Basel accords. We also reviewed provisions in the Dodd-Frank Act and the proposed risk retention rules that applied to lenders specifically and interviewed industry stakeholders about the potential impact of a risk retention requirement on different types and sizes of mortgage lenders. To illustrate the potential capital impacts of different forms of risk retention, we developed a hypothetical securitization based on research and industry information about the size and structure of RMBS. We used regulatory capital risk weights used by federal banking regulators to calculate the capital charges for horizontal and vertical risk retention to estimate the total amount of regulatory capital that a securitizer would have to hold for each option. Because this example is meant to be illustrative, we did not apply all regulatory capital or accounting standards that could influence the capital impacts of the risk retention requirement, including the FAS 166 and 167 accounting statements.

To assess the advantages and disadvantages of a uniform 5 percent risk retention requirement, we reviewed available information on past risk retention practices. We also interviewed industry stakeholders about these practices and information that should be considered in comparing the merits of a uniform and a nonuniform requirement. Additionally, we interviewed federal rulemakers and mortgage industry stakeholders (including representatives from financial services companies and mortgage and securities analysts) about the development, implementation, and enforcement of both a uniform and a nonuniform requirement.

Assessment of Housing Counseling and HOEPA Provisions

To describe the potential effects of consumer protection provisions in the Dodd-Frank Act for housing counseling and high-cost HOEPA loans, we reviewed relevant statutory provisions and regulations. We also reviewed information from HUD regarding its current housing counseling assistance program, including data on the counseling services provided by HUD-approved counseling agencies from 2006 through 2010. We identified and reviewed empirical research on the impact of foreclosure mitigation and prepurchase housing counseling, HUD reports, and relevant academic and industry literature about housing counseling research and policy. We also interviewed officials from HUD's Office of Single-Family Housing and Office of Policy Development and Research, and officials from organizations currently conducting housing counseling research, including Fannie Mae, the Federal Reserve Bank of Philadelphia, and the Urban Institute. With respect to HOPEA, we compared the Dodd-Frank Act's new requirements for high-cost loans to previous statutory requirements and examined available research on the number of loans originated from 2004 through 2009 that were covered by HOEPA. We interviewed a wide range of mortgage and counseling industry stakeholders, including consumer groups, lenders, academic researchers, and housing counseling intermediaries (organizations that channel HUD counseling funds to local, affiliated counseling agencies) about the Dodd-Frank Act's counseling and HOEPA provisions.

We conducted this performance audit from August 2010 to July 2011 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix II: Proportions of Mortgages Meeting Selected Qualified Mortgage Criteria in Geographic Groupings Based on Demographic and Housing Market Characteristics

In contemplating the potential impact of QM criteria, one consideration is the extent to which mortgages made to different borrower groups and within different housing markets would have met selected QM criteria. Using the CoreLogic database described in more detail in appendix I, we examined the percentages of mortgages originated within various geographic groupings that would have met selected QM criteria from 2001 through 2010 and compared them with the corresponding percentages for all borrowers.[1] We applied each criterion separately. We looked at ZIP codes grouped by race, ethnicity, and income level to examine the proportions of mortgages in each grouping that likely would have met the four QM criteria for which the CoreLogic database had relevant information (mortgage does not have a negative amortization feature, mortgage term does not exceed 30 years, mortgage does not include balloon payments, and mortgage complies with regulations relating to DTI ratio).[2] Using 2000 Census data, the most recent data available as of June 2011, we grouped ZIP codes associated with the mortgages in the CoreLogic database into three categories: black or African-American households made up 75 percent or more of the population, Hispanic or Latino households made up 75 percent or more of the population, and median incomes were less than 80 percent of the median income of the associated metropolitan statistical area (low income).[3] We also grouped states into two categories: one containing states that experienced rapid house price appreciation followed by rapid depreciation (severe housing bubble states) during the 2000s, and all other states. The severe housing bubble states were Arizona, California, Florida, and Nevada. Except where noted below, for this appendix we used a dataset that combined the mortgages in the prime, near-prime, and government-insured category of the CoreLogic database with the mortgages in the subprime category.

[1]We did not examine the reasons for differences among the various groupings or the performance of the mortgages for each grouping as part of our analysis. In a prior report, we examined statistical associations between a number of loan and borrower characteristics—including borrower race, ethnicity, and reported income—and the probability of default. See GAO-10-805.

[2]For DTI ratio, we used the 41 percent figure that serves as a guideline in underwriting FHA-insured mortgages.

[3]The groupings we examined are not mutually exclusive, but our analysis did not allow us to assess the separate effects of borrower income, race, and ethnicity.

Our analysis of the QM criterion prohibiting negative amortization features found that in ZIP codes with high proportions of black or African-American households, the percentages of mortgage originations that met the criterion were generally similar to the percentages for all borrowers, with the exception of 2004 through 2006 when the proportions were approximately 2 to 4 percentage points higher (see table 2). In ZIP codes with high proportions of Hispanic or Latino households, the percentages of mortgage originations that met the criterion were similar to those for all borrowers, although they were somewhat lower (about 3 percentage points) from 2005 through 2007. In low-income ZIP codes, the proportions of mortgage originations that met the criterion in all years were similar to the proportions for all borrowers. In severe housing bubble states, the proportions of mortgage originations from 2003 through 2007 that met the criterion were about 2 to 7 percentage points lower than they were for all borrowers. In all other states, the proportions of mortgage originations that met the criterion were similar in all years to the proportions for all borrowers, except from 2005 through 2007, when they were from 2 to 3 percentage points higher.

Table 2: Percentage of Mortgages Meeting Qualified Mortgage Repayment of Principal Requirement, by Demographic and Housing Market Grouping, 2001-2010

	Year									
Grouping	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
All borrowers	99.0%	99.8%	99.8%	96.0%	93.4%	94.2%	96.4%	99.4%	100.0%	100.0%
ZIP codes with 75% or greater black or African-American population	99.7	99.5	99.3	98.1	97.1	96.7	96.7	99.1	100.0	100.0
ZIP codes with 75% or greater Hispanic or Latino population	99.0	98.6	98.9	95.5	90.1	89.8	92.3	98.5	100.0	100.0
Low-income ZIP codes	99.0	98.6	98.5	95.9	92.9	93.4	95.2	99.1	100.0	100.0
Severe housing bubble states	97.5	97.2	97.4	92.3	86.5	87.3	91.7	98.4	100.0	100.0
All other states	99.6	99.4	99.4	97.7	96.7	97.3	98.2	99.7	100.0	100.0

Source: GAO analysis of Census 2000 and CoreLogic data.

Our analysis of the QM criterion for amortization terms of 30 years or less found that in ZIP codes with high proportions of black or African-American households, the percentages of mortgage originations that met the criterion were generally similar to those for all borrowers, exception of 2006 through 2008, when the proportions were approximately 2 to 4 percentage points lower (see table 3). In ZIP codes with high proportions of Hispanic or Latino households, the percentages of mortgage originations that met the criterion were similar to those for all borrowers, although they were somewhat lower (about 2 to 3 percentage points) from 2006 through 2008. In low-income ZIP codes, the proportions of mortgage originations that met the criterion were similar to those for all borrowers, with the exception of 2006 and 2007, when the proportion was nearly 2 percentage points lower. In severe housing bubble states, the proportions of mortgage originations that met the criterion were similar to the proportions for all borrowers, with the exception of 2006 and 2007, when it was 3 to 4 percentage points lower. In all other states, the proportions of mortgage originations that met the criterion in all years were similar to the proportions for all borrowers.

Table 3: Percentage of Mortgages Meeting Qualified Mortgage Criterion for Loan Terms of 30 Years or Less by Demographic and Housing Market Grouping, 2001-2010

	Year									
Grouping	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
All borrowers	99.8%	99.8%	99.8%	99.6%	98.0%	94.1%	95.1%	98.8%	99.8%	99.8%
ZIP codes with 75% or greater black or African-American population	99.4	99.4	99.6	99.5	97.6	91.7	91.1	97.2	99.5	99.9
ZIP codes with 75% or greater Hispanic or Latino population	99.8	99.8	99.8	99.7	96.9	90.9	92.6	97.2	99.8	99.9
Low-income ZIP codes	99.7	99.7	99.7	99.6	97.4	92.6	93.6	98.4	99.8	99.8
States that experienced severe housing bubbles	99.8	99.8	99.8	99.4	96.5	90.2	92.3	98.3	99.9	99.9
All other states	99.8	99.8	99.8	99.6	98.6	95.8	96.1	99.0	99.8	99.8

Source: GAO analysis of Census 2000 and CoreLogic data.

Our analysis of the QM criterion restricting balloon payments found that in ZIP codes with high proportions of black or African-American households or Hispanic or Latino households, the percentages of mortgage originations that met the criterion were generally similar to those for all borrowers, with the exception of 2006, when the proportions were nearly 2 percentage points lower for both ZIP code groupings (see table 4). In low-income ZIP codes, severe housing bubble states, and all other states, the proportions of mortgage originations that met the criterion in all years were similar to the proportions for all borrowers.

Table 4: Percentage of Mortgages Meeting Qualified Mortgage Criterion Restricting Balloon Payments by Demographic and Housing Market Grouping, 2001-2010

	Year									
Grouping	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
All borrowers	99.2	99.2%	99.1%	99.4%	99.1%	97.7%	98.9%	100.0%	100.0%	100.0%
ZIP codes with 75% or greater black or African-American population	97.8	98.9	99.4	99.3	98.4	96.0	97.5	100.0	100.0	100.0
ZIP codes with 75% or greater Hispanic or Latino population	99.6	99.7	99.8	99.6	98.5	95.8	98.2	100.0	100.0	100.0
Low-income ZIP codes	98.9	99.3	99.3	99.4	98.7	97.0	98.4	100.0	100.0	100.0
Severe housing bubble states bubbles	99.5	99.4	99.3	99.6	98.9	96.7	98.4	100.0	100.0	100.0
All other states	99.1	99.1	99.0	99.3	99.2	98.2	99.1	100.0	100.0	100.0

Source: GAO analysis of Census 2000 and CoreLogic data.

Due to limitations in the CoreLogic database, our examination of the criterion for DTI ratio was restricted to mortgages in the prime, near-prime, and government-insured category for 2003 through 2010. Using a hypothetical standard of 41 percent or less for DTI ratio, we found that in ZIP codes with high proportions of black or African-American households, the percentages of mortgage originations that met the criterion were generally lower than those for all borrowers, ranging from 1 percentage point less in 2004 and 2006 to 10 percentage points less in 2009 (see table 5). In ZIP codes with high proportions of Hispanic or Latino households, the proportions of mortgage originations that met the criterion were also generally lower than the proportions for all borrowers, ranging from about 3 percentage points less in 2006 and 2007 to 15 percentage points less in 2010. In low-income ZIP codes, the proportions of mortgage originations that met the criterion were generally lower than the proportions for all borrowers, ranging from 2 percentage points less in 2004 to nearly 5 percentage points less in 2010. In severe housing bubble states, the proportions of mortgage originations that met the criterion were generally lower than the proportions for all borrowers, ranging from less than 1 percentage point lower in 2004 and 2005 to 5 percentage points lower in 2010. In all other states, the proportions of mortgage originations that met the criterion in all years were similar to those for all borrowers, except in 2010, when the proportion was 2 percentage points higher.

Table 5: Percentage of Prime, Near-Prime, and Government-Insured Mortgages Meeting a Hypothetical Qualified Mortgage Criterion for DTI Ratio of 41 Percent or Less by Demographic and Housing Market Grouping, 2003-2010

	Year							
Grouping	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
All borrowers	75.2%	71.9%	65.5%	62.1%	58.3%	58.5%	64.9%	64.8%
ZIP codes with 75% or greater black or African-American population	70.6	70.6	63.2	60.8	56.8	51.9	55.1	57.2
ZIP codes with 75% or greater Hispanic or Latino population	69.6	65.4	61.2	59.2	55.5	49.7	50.5	49.8
Low-income ZIP codes	72.6	69.9	65.8	62.2	57.9	55.9	61.3	60.2
Severe housing bubble states	74.9	70.9	64.4	60.4	56.2	54.9	60.7	59.5
All other states	75.3	72.3	66.1	62.9	59.2	59.7	66.3	66.6

Source: GAO analysis of Census 2000 and CoreLogic data.

Note: This analysis only includes mortgages in the prime, near-prime, and government-insured category of the CoreLogic database. Because the CoreLogic database did not contain sufficient information on DTI for prime, near-prime, and government-insured mortgages originated in 2001 and 2002, we only present data for 2003 through 2010. For this latter period, about 53 percent of the mortgages did not have information on the DTI ratio. We concluded that those mortgages were likely not systematically different from mortgages with DTI information based on a comparison of the average borrower credit scores associated with both groups of mortgages, which showed little difference.

Appendix III: Comments from the National Credit Union Association

National Credit Union Administration

Office of the Chairman

VIA E-MAIL

July 11, 2011

Mr. William B. Shear
Director
Financial Markets and Community Investment
U.S. Government Accountability Office
441 G Street, NW
Washington, DC 20548

Dear Mr. Shear:

We reviewed the draft report "Potential Impacts of Provisions in the Dodd-Frank Act on Homebuyers and the Mortgage Market." The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act) directed GAO to assess the effect of mortgage-related provisions on the availability and affordability of mortgage credit. As noted in the report, federal agencies are still developing the regulations for some of these provisions, with rulemaking agencies accepting public comments on proposed risk retention regulations through August 1, 2011. Therefore, our comments on this draft report will be general, since the impact of the Act largely depends upon other key regulatory decisions which have not been made.

According to the Act, a lender is presumed to have satisfied the ability-to-repay requirement when it originates a "qualified mortgage" (QM). The report contains thorough analysis on five of the nine QM criteria specified in the Act for which sufficient data were available. The five criteria were (1) payment of loan principal, (2) length of the mortgage term, (3) scheduled lump-sum payments, (4) documentation of borrower resources, and (5) borrower debt burdens. The report generally found that for each year from 2001 to 2010, most mortgages would likely have met the individual criteria for these five elements prescribed in the Act. We also note the trends provided in the report show mortgage originators improved their underwriting standards in 2009-2010 based on the adverse loss trends, which address many of the criteria studied by GAO.

One of NCUA's key concerns is the lack of a mechanism for non-QM loans to receive QM status through seasoning. While the report found that most loans originated for the time period studied met the criteria when analyzed individually, the impact of simultaneously applying multiple criteria creates a much narrower population for QM loans. Moreover, borrower debt burdens (the fifth element) appear to be the most difficult element for borrowers to achieve. This may be especially true for those of modest means. Creating a mechanism for lenders to originate non-QM loans that could become QM loans after a specific period of time expires may help achieve the goal of protecting borrowers from unsustainable mortgage products while maintaining broad access to mortgage credit.

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Mr. William B. Shear
July 11, 2011
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NCUA appreciates the detailed analysis performed by GAO. Thank you for the opportunity to comment on this draft report.

Sincerely,

Debbie Matz
Chairman

Appendix IV: GAO Contact and Staff Acknowledgments

GAO Contact

William B. Shear, (202) 512-8678 or shearw@gao.gov

Staff Acknowledgments

In addition to the individual named above, Steve Westley (Assistant Director), Meghana Acharya, Serena Agoro-Menyang, William Bates, Stephen Brown, Emily Chalmers, Matthew McDonald, John McGrail, Timothy Mooney, Lisa Moore, Alise Nacson, and Jim Vitarello made key contributions to this report.

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