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A legal update from Dechert's Financial Institutions and Finance and Real Estate Practice Groups

Risk Retention and Residential Mortgages: Legislation, Regulation and Economics

In enacting the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), Congress created a broad new regulatory scheme to correct what, in its view, were structural failures of quality and accountability in the residential mortgage origination market (Titles X and XIV) and the residential mortgage-backed securities ("RMBS") market (Title IX).

In Dodd-Frank, Congress took a nuanced approach that utilizes incentives rather than mandates. Rather than expressly outlawing particular types of mortgage options, Title XIV generally provides incentives for originators to make residential loans that meet Congressional preferences aimed at improving asset quality and protecting borrowers. As part of the process, the Consumer Financial Protection Bureau ("CFPB") is charged with defining the characteristics of a qualifying mortgage ("QM"), *i.e.*, one that will receive favorable regulatory treatment.

Similarly, Congress approached reform of the RMBS market through *incentives* rather than *prohibitions*. Under Section 941 of Dodd-Frank, securitizers will remain free to offer a full range of mortgage types to the market, albeit subject to enhanced due diligence and disclosure requirements. While retaining that freedom, securitizers, however, will be required to hold a 5% interest in the RMBS that they issue. Here again, Congress designed an incentive. A securitization consisting exclusively of qualifying residential mortgages ("QRMs") would not be subject to any risk retention requirement. The agencies have proposed what are generally viewed as very strict standards for a loan to qualify as a QRM. See our March [DechertOnPoint FDIC Acts on Proposed Risk Retention Rule for Asset-Back Securities](#).

At first blush, a critical question will be the extent to which originators and securitizers will be prepared to deal in non-QRM loans. If the 5% risk retention requirement were to effectively shut down the origination of non-QRM loans, that would have a dramatic impact on the nation's housing finance system and the economy. Alternatively, the requirement might present an opportunity for lenders to offer non-QRM borrowers access to housing credit, albeit at higher rates than those for QRM borrowers. Did Congress consider which of these two scenarios was more likely, and which was more desirable, when it enacted Dodd-Frank?

Under the proposed risk retention rule ("Rule"), the foregoing scenarios do not actually come into play, at least for the foreseeable future. In enacting Dodd-Frank, Congress excluded securitizations that involved assets guaranteed by the United States or agencies of the United States, but expressly prevented Fannie Mae and Freddie Mac ("GSEs") from being treated as U.S. agencies. In the weeks immediately preceding the release of the Rule there was increasing interest in how GSE-guaranteed mortgage securities would be treated under the proposal. The agencies decided that they would propose to treat mortgage-backed securities fully guaranteed as to principal and interest by the GSEs as meeting the risk retention requirements of the Rule without any additional

action by the GSEs, as long as they remain in conservatorship and have capital support from the United States. As a practical matter, the vast majority of non-government guaranteed RMBS in the U.S. today are GSE securitizations.

Under the Rule, the GSEs can continue to guarantee whatever types of mortgage loans they are prepared to guarantee, without consideration for whether the loans meet the QRM standard. Since there is no new risk retention requirement applicable to the GSEs, it would appear that the GSEs will not have to consider whether to seek voluntary agreement from individual originators to share in the economics of risk retention as permitted under the Rule.

The Administration has indicated that it expects that the temporary increase in GSE-conforming loan limits will end on October 1, 2011 as scheduled. This means that there will be an increase in the potential volume of non-GSE related loan originations by the end of this year. Congress, the regulators, industry participants and the public will no doubt be interested in the extent to which non-QRM loans will be available in this higher loan-amount sector.

More immediately, the GSE treatment aspect of the Rule has attracted the attention of Congress. On March 29, Congressman Scott Garrett (R-NJ) introduced H.R. 1223 that would amend Section 941 of Dodd-Frank to require that mortgages held or securitized by the GSEs would be treated similarly to other mortgages or RMBS for purposes of risk retention requirements. This would effectively undo the GSE treatment contained in the Rule. The bill is co-sponsored by House Financial Services Committee Chairman Spencer Bachus (R-AL) and Vice-Chair Jeb Hensarling (R-TX). It is also reported to have the support of Representative Barney Frank (D-MA), Ranking Member of the House Financial Services Committee.

H.R. 1223 raises a host of important issues:

- If enacted, the GSEs would have to consider whether, or to what extent, they might limit their guarantee activity to QRM qualifying loans. If this were to occur, it would place even more focus on how restrictive the final definition of a QRM would be. It would also place a high level of attention on the CFPB's upcoming decision regarding the definition of a QM, since the QRM definition can be no broader than the QM definition.
- If the GSEs were to limit guarantees to QRM qualifying loans, this could have the overall impact of sharply restricting the availability of housing finance. At the same time, it could trigger the emergence of a private sector securitization market that would offer RMBS composed of non-QRM loans in the GSE conforming loan-size sector.
- If the GSEs were to guarantee only non-QRM loans, they would have to consider how they would manage the risk retention requirements, which would potentially add RMBS holdings to their balance sheets at the same time that they were under a mandate to reduce their RMBS holdings. This, in turn, could spur the GSEs to look to share the economics of risk retention with their originating institutions. Adding a risk retention component to the mortgage origination activities of the wide range of institutions that originate GSE-guaranteed transactions could have a significant impact on the economics of this business, especially for smaller financial institutions.
- The foregoing factors could spur a movement of commenters to request that the agencies create a category of non-QRM loans that are nevertheless high quality that would be accorded a less than 5% risk retention requirement which could blunt the potentially contractionary impact of a possible retrenchment to a QRM-only origination environment.

Conclusion

The Administration's Housing Finance Reform proposal envisions a housing finance sector in which lending standards are significantly tightened and rental housing plays a larger role. See our February [DechertOnPoint Administration Report Offers New Directions for the Federal Role in Housing Finance](#). At the same time, the Administration's proposal emphasizes the importance of avoiding instability in the housing sector. It now seems likely that the process of implementing the risk retention provisions of Section 941 of Dodd-Frank will play a central, if not fully anticipated, role in shaping the market for residential housing finance. As a result, we can expect a major public policy debate over the final elements of the risk retention rules to take shape during the next several months.

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This update was authored by Patrick D. Dolan (+1 212 698 3555; patrick.dolan@dechert.com), Robert H. Ledig (+1 202 261 3454; robert.ledig@dechert.com), Ralph Mazzeo (+1 215 994 2417; ralph.mazzeo@dechert.com), Thomas P. Vartanian (+1 202 261 3467; thomas.vartanian@dechert.com), Gordon L. Miller (+1 202 261 3467; gordon.miller@dechert.com), Laurie J. Nelson (+1 215 994 2495; laurie.nelson@dechert.com), Kira N. Brereton (+1 212 698 3574; kira.brereton@dechert.com) and Robert F. Alleman (+1 212 698 3565; robert.alleman@dechert.com).

Practice group contacts

For more information, please contact the authors, one of the attorneys listed or any Dechert attorney with whom you regularly work. Visit us at our [Financial Institutions](#) and [Finance and Real Estate](#) pages.

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David L. Ansell

Washington, D.C.
+1 202 261 3433
david.ansell@dechert.com

Timothy J. Boyce

Charlotte
+1 704 339 3129
timothy.boyce@dechert.com

Lewis A. Burleigh

Boston
+1 617 654 8601
lewis.burleigh@dechert.com

Katherine A. Burroughs

Hartford
+1 860 524 3953
katherine.burroughs@dechert.com

Laura G. Ciabarra

Hartford
+1 860 524 3926
laura.ciabarra@dechert.com

Patrick D. Dolan

New York
+1 212 698 3555
patrick.dolan@dechert.com

Malcolm S. Dorris

New York
+1 212 698 3519
malcolm.dorris@dechert.com

Dr. Olaf Fasshauer

Munich
+49 89 21 21 63 28
olaf.fasshauer@dechert.com

Steven A. Fogel

London
+44 20 7184 7444
steven.fogel@dechert.com

David W. Forti

Philadelphia
+1 215 994 2647
david.forti@dechert.com

William Fryzer

London
+44 20 7184 7454
william.fryzer@dechert.com

David J. Harris

Washington, D.C.
+1 202 261 3385
david.harris@dechert.com

Joseph B. Heil

San Francisco
+1 415 262 4510
joseph.heil@dechert.com

Bruce D. Hickey

Boston
+1 617 654 8602
bruce.hickey@dechert.com

Geoffrey K. Hurley

New York
+1 212 698 3598
geoffrey.hurley@dechert.com

Andrew Hutchinson

London
+44 20 7184 7428
andrew.hutchinson@dechert.com

Richard D. Jones

Philadelphia
+1 212 698 3844
richard.jones@dechert.com

Robert H. Ledig

Washington, D.C.
+1 202 261 3454
robert.ledig@dechert.com

David M. Linder

San Francisco
+1 415 262 4511
david.linder@dechert.com

Ralph R. Mazzeo

Philadelphia
+1 215 994 2417
ralph.mazzeo@dechert.com

Jason S. Rozes

Philadelphia
+1 215 994 2830
jason.rozes@dechert.com

Timothy A. Stafford

New York
+1 212 698 3504
timothy.stafford@dechert.com

William C. Stefko

New York
+1 212 698 3895
william.stefko@dechert.com

Laura Swihart

New York
+1 212 698 3644
laura.swihart@dechert.com

Barry J. Thorne

London
+44 20 7184 7413
barry.thorne@dechert.com

Thomas P. Vartanian

Washington, D.C.
+1 202 261 3439
thomas.vartanian@dechert.com

Jay Zagoren

Philadelphia
+1 215 994 2644
jay.zagoren@dechert.com

John M. Timperio

Charlotte
+1 704 339 3180
john.timperio@dechert.com

Cynthia J. Williams

Boston
+1 617 654 8604
cindy.williams@dechert.com



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