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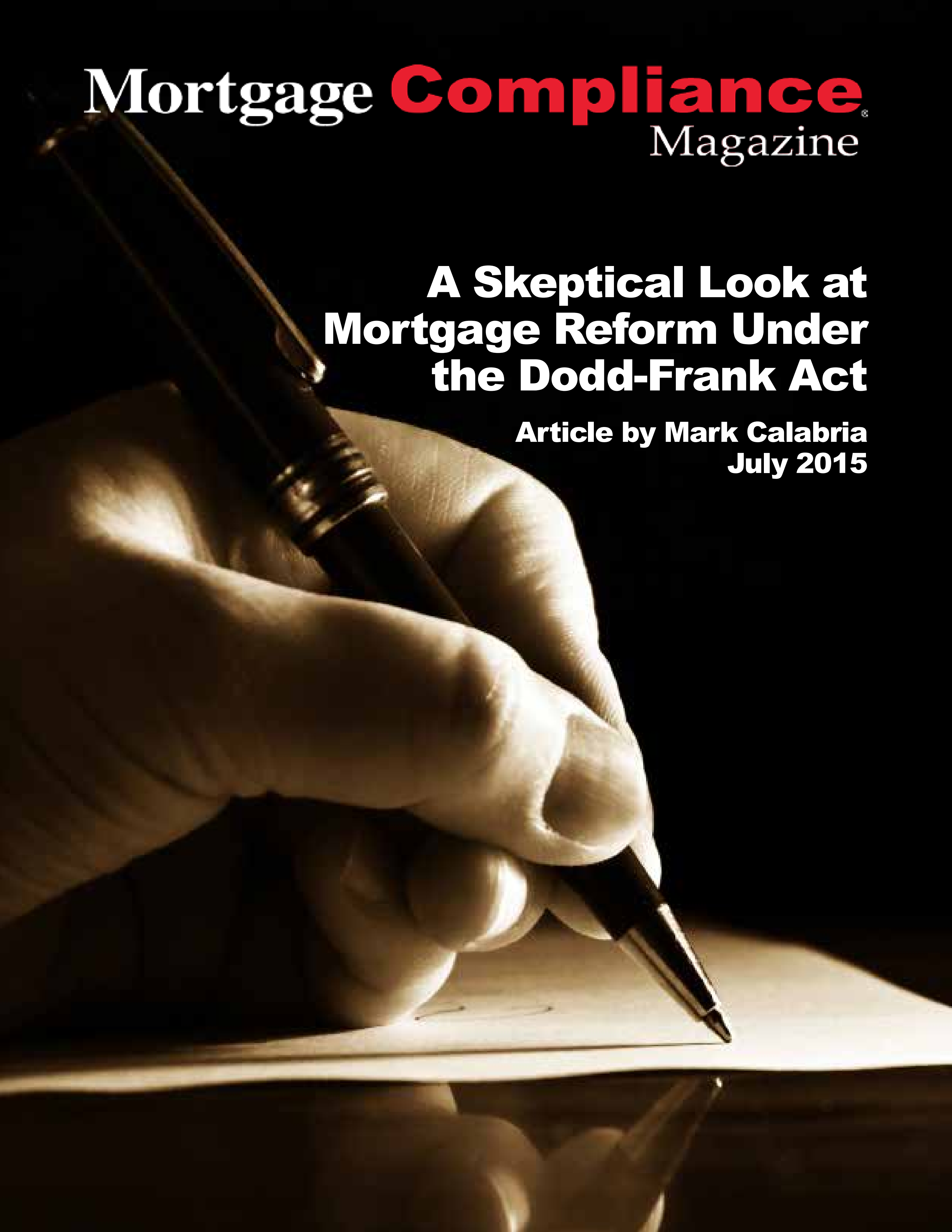

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Article by Mark Calabria
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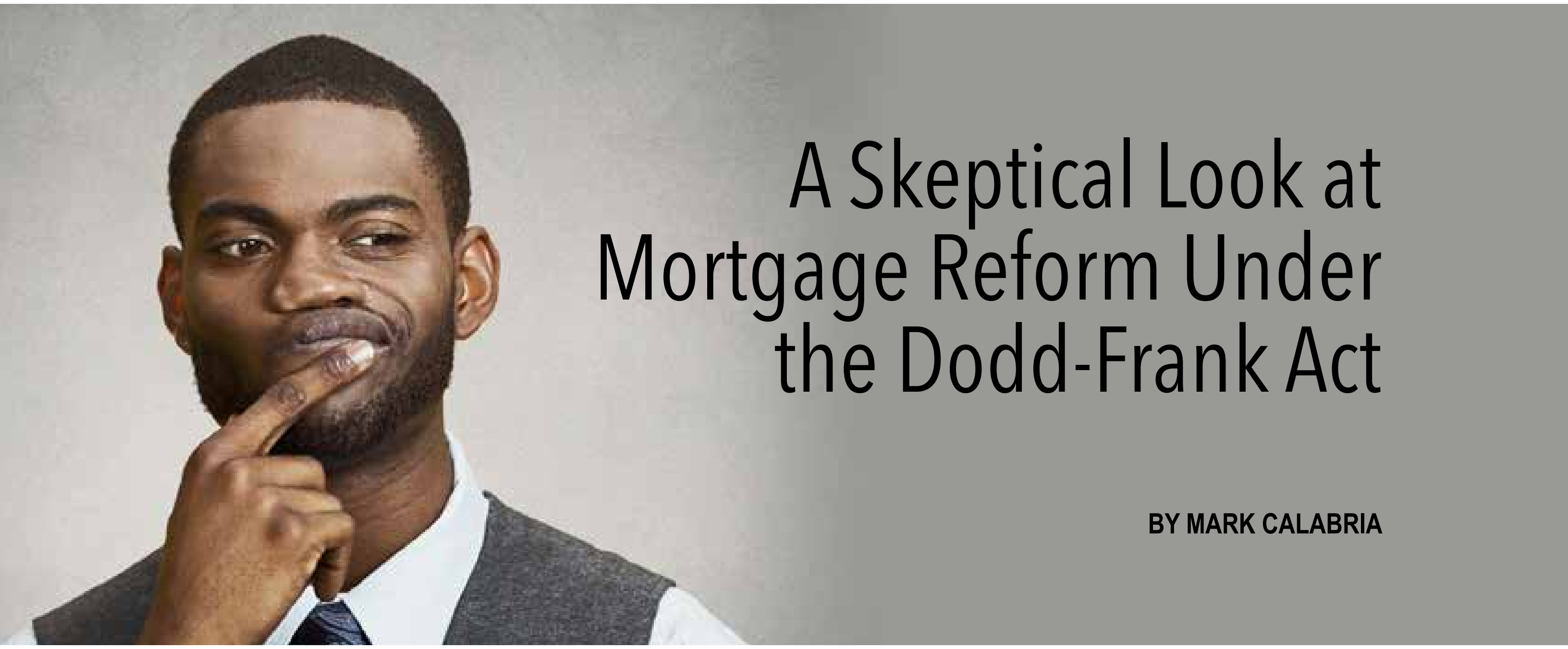

A Skeptical Look at Mortgage Reform Under the Dodd-Frank Act

BY MARK CALABRIA

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Most accounts of the financial crisis of 2008 include a prominent role for the U.S. residential mortgage market. Although other property markets exhibited similar boom and bust patterns, the elevated level of defaults and associated costs borne by the taxpayer have brought a particular emphasis on single-family mortgage finance policies. It should be of little surprise that the Dodd Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) contains multiple provisions related to mortgage finance.

Dodd-Frank's sixteen separate titles contain a number of provisions impacting the mortgage market. The financial services law firm Davis Polk & Wardwell LLP (Davis Polk) estimates that Dodd-Frank will require 49 separate instances of rule-making in the area of mortgage reform alone. Of particular importance are those found in Titles IX, X and XIV. Despite the extensive expansion of mortgage regulation under Dodd-Frank, it is unlikely that such changes will significantly reduce mortgage defaults or mitigate future booms and busts in the housing market.

DODD-FRANK AND 'PREDATORY LENDING'

One narrative of the financial crisis attributes the increase in mortgage defaults to 'predatory lending.' Dodd-Frank's attempt to address predatory lending is contained in Title XIV, also labeled the Mortgage Reform and Anti-Predatory Lending Act. Despite the name, there is no actual definition of predatory lending contain in Title XIV, but rather a collection of prohibitions and restrictions. The major substantive provisions of Title XIV are structured as amendments to the Truth in Lending Act. Title XIV somewhat mirrors the anti-predatory lending statutes passed in North Carolina beginning in 1999.

A recurring theme in Dodd-Frank's mortgage reforms is the assumption that many borrowers were simply in the 'wrong' loan. Along this line of thinking, mortgage originators are prohibited from 'steering' borrowers toward loans that have certain features or for which the borrower lacks a reasonable ability to pay. Originators are also prohibited from mischaracterizing either the credit history of the borrower or their loan options. The intent here reflects a belief that many prime borrowers were steered into subprime products. In general, originators placing borrowers into qualified mortgages (QM) will be protected from enforcement and liability.

On January 10, 2013, the Consumer Financial Protection Bureau (CFPB) issued final rules implementing Dodd-Frank's Title XIV Subtitle B, more commonly known as the Qualified Mortgage Rule. As the QM rule amends the Truth in Lending Act, violations of the QM that fall outside its safe harbor subject lenders to significant liability. Delinquent borrowers can also use violations of the QM rule as a defense to foreclosure proceedings.

The heart of the QM standards is found in Section 1411's Ability-To-Repay (ATR) Rule requirements. Section 1411 prohibits lenders from making a residential mortgage unless the lender makes a good faith determination that the borrower has a reasonable ability to repay the loan. While Section 1411 does provide some guidance on what constitutes a good faith determination and what is reasonable, considerable discretion remains in interpreting these terms. Due to concerns over the lack of clarity in the Ability-To-Repay standard, Dodd-Frank's Section 1412 allows for the creation of a safe harbor from liability for lenders if loans meet the definition of a qualified mortgage. It is in minimizing liability risk that lenders will attempt to meet the standards for a qualified mortgage.

Compliance with the Ability-To-Repay requirements is likely to be both costly and extensive. What data is to be collected? How is that data audited? How long is it stored? How does the originator create a clear audit trail that can be shared and verified by both servicers and investors? These are all difficult and subjective questions where the cost of being wrong will be significant.

Similar to the Qualified Residential Mortgage (QRM) Rule finalized in October 2014, the statutory restrictions on QM ban certain mortgage features, such as interest only, balloon payments, and negative amortization. Section 1412 also limits points and fees to no more than 3 percent of the loan amount. For adjustable rate mortgages (ARM), Section 1412 requires loans to be underwritten at the maximum possible rate during the first five years of the loan. Loan terms may not exceed 30 years. Income and financial resources must be fully documented. Dodd-Frank's Title XIV contains additional prohibitions that go beyond its Ability-To-Repay requirements. Specifically, Section 1414 severely limits the use of prepayment penalties, prohibiting them for non-QM loans and capping their amount and duration for QM loans. Despite the increased liability from Title XIV or, perhaps, because of it, lenders are prohibited from requiring mandatory arbitration for all residential mortgages. Even if that did not increase liability costs, it is likely to increase the variance of liability costs. Section 1414 also requires lenders to make borrowers aware of their ability to 'walk away' in anti-deficiency states. Section 1417 increases civil money penalties under the Truth in Lending Act, of which both QM and the Home Ownership and Equity Protection Act (HOEPA) are part.

SKIN IN THE GAME

One of the more interesting approaches to managing mortgage risk is Dodd-Frank's Section 941's Regulation of Credit Risk Retention, which prohibits the issuance of any asset-backed security under the Securities Exchange Act of 1934 (1934 Act) unless 1) the issuer retains "not less than five percent of the credit risk for any asset that is not a qualified residential mortgage" or 2) meets the definition of a qualified residential mortgage. While Section 941's risk retention requirement applies to any asset-backed security (ABS) issued under the 1934 Act, Dodd-Frank gives broad discretion to the Securities and Exchange Commission (SEC) to make such determinations for ABS that do not contain residential mortgages.

Unlike other classes of ABS, Section 941, which adds a new Section 15G to the 1934 Act, establishes a number of statutory criteria to guide the regulatory QRM definition. These statutory requirements include: 1) documentation of the borrower's financial resources; 2) debt-to-income standards; 3) mitigation of payment shock for adjustable rate products; 4) consideration of other credit enhancements; and, 5) the restriction of loan terms that have been demonstrated to exhibit a higher risk of borrower default.

Dodd-Frank explicitly exempts Federal Housing Administration, Veterans Administration, and Rural Housing Service and Farm Credit loans from the risk retention requirements. Regulators have discretion over extending that exemption to loans securitized by Fannie Mae or Freddie Mac.

By construction, mortgages held in portfolio would be exempt from the QRM requirements. An open question is to what extend would the QRM requirements drive even loans held in portfolio, as the option to later sell those loans into the secondary market could influence initial origination decisions. Even during the height of the housing boom in 2006, a significant portion, approximately a fifth of both subprime and conforming loans, were not securitized. Among jumbo mortgages, the percentage securitized first broke 50 percent in 2007, after which such percent subsequently declined in 2008 and 2009 to the single digits.

As the QRM is also an amendment to the 1934 Act, mortgage-backed securities (MBS) issues that are later determined to be non-QRM would subject the issuer to liability under SEC Rule 10b-5. Given the subjectivity in some of the documentation requirements under QRM and potential Rule 10b-5 liability, lenders can expect increased documentation and verification costs. Issuers should also brace themselves for investor litigation during the next housing bust.

IMPACT OF DODD-FRANK ON MORTGAGE AVAILABILITY

A goal of the Dodd-Frank Act is to eliminate certain products and practices from the mortgage market. So, at a very basic level, the choices facing mortgage borrowers will be reduced; the difficult question is in gauging how much.

At least three independent attempts have been made to estimate the impact of QRM and/or QM on mortgage availability. These three analyses were performed by the United States Government Accountability Office (GAO), the Federal Housing Finance Agency (FHFA), and the private firm CoreLogic®. GAO's analysis is based predominately on CoreLogic® data, so, unsurprisingly, their conclusions are similar. FHFA's analysis is based upon its collection of Fannie Mae and Freddie Mac mortgage data. None of these studies attempt to incorporate behavioral changes and hence are likely to overestimate the impact of the QRM/QM rules. These studies also do not incorporate the impact of house price changes. If, for instance, the QRM/QM reduces the demand for housing, then housing prices should fall, which would off-set the reduced demand. Impacts of the QRM/QM, in theory, are ambiguous as to net impact on homeownership rates.

The three studies yield similar conclusions as to the impact of QRM. The most restrictive provision of the QRM Rule would be the ceiling on allowable debt-to-income ratios (DTI). A number of QRM restrictions are likely to have very modest impacts as their prevalence in the mortgage market was generally low. Both the QM and QRM Rules ban negative amortization features; yet, according to GAO's analysis, "almost 100 percent of [subprime] mortgage originations from 2001 to 2007 did not have negative amortization features." Within the prime market, the percent with negative amortization features peaked in 2005 at nine percent (9%). The average between 2001 and 2010 was closer to one percent (1%). The disappearance of negative amortization mortgages will not be noticed by the vast majority of participants in the mortgage market. To the extent that a small number of borrowers used negative amortization products to smooth income volatility, these households will be left worse off under Dodd-Frank's restrictions on negative amortization. If we return to the high levels of inflation witnessed in the 1970s, certain products, such as negative amortization, which gained acceptance as a reaction to high levels of inflation, may return. QRM could pose an obstacle to the return of products geared toward managing high levels of inflation.

Dodd-Frank also places limitations on mortgages with terms in excess of 30 years. In the prime and near-prime market, essentially 100 percent of mortgages were under a 30-year term until about 2005, where longer than 30-year mortgages grew slowly to four percent (4%) of the market in 2007 before disappearing by 2009. Subprime followed a more unusual situation with nearly 100 percent of subprime being under 30 years until 2005 and 2006, when the share over 30 years peaked at 15 percent of the subprime market. As longer loan terms allow borrowers to make higher house price bids while maintaining a constant monthly payment, the growth in this market segment likely reflected a last ditch attempt by some subprime borrowers to purchase before the boom was over. Some amount of these loans may have reflected an attempt to refinance into lower monthly payments. Given the relatively small share of mortgages with durations over 30 years, this Dodd-Frank restriction will also likely be quite minor. Another loan feature restricted by Dodd-Frank is the use of balloon payments, where the mortgage does not fully amortize over its term leaving a balance due upon maturity. Final balloon payments are multiples of the monthly payment. Despite the prevalence of balloon loans before the ▷

New Deal mortgage reforms of the 1930s, these products were generally rare, even during the height of the recent boom. GAO reports that almost 100 percent of prime, near-prime, and government-insured mortgages lacked any balloon features between 2001 and 2010. Among subprime loans, balloon features were also rare, close to zero until 2005 when they grew to about 10 percent of subprime loans in 2007, after which they have largely disappeared from the subprime market. Both the QM and QRM place restrictions upon borrower documentation, particularly in the area of income. A common concern is that no- or low-documentation loans lead to greater levels of fraud and higher losses in the mortgage market than would have occurred otherwise. Whereas the QRM is an obstacle for securitization, the QM standards come with substantial and uncertain liability; so, while there is likely to be a market for non-QRM loans, non-QM loans will become rare. By GAO's estimates, the percentage of subprime loans lacking full documentation ranged from 40 percent in 2006 to 20 percent in 2001. A similar, but smaller, trend was witnessed among prime loans, where those lacking full documentation ranged from around 20 percent in 2006 to almost zero in the early 2000s. The documentation requirements under QM/QRM are likely to impact most self-employed borrowers. As there are over 15 million self-employed individuals in the United States, these restrictions could be significant.

Loans that do not meet the QRM requirements can still be securitized, with the caveat that the issuers must retain not less than five percent (5%) of the credit risk of the securitized asset pool. Issuers are also prohibited from hedging or otherwise transferring this risk. Ultimately, the greater risk from the QRM is likely to be liability under the securities laws rather than the retention of a sliver of credit risk.

IMPACT OF DODD-FRANK ON MORTGAGE DEFAULT

The Dodd-Frank Act is a response to the theory that 'bad' mortgage lending and lenders drove borrowers into default, which ultimately drove the housing market into decline leading to a fall in the value of mortgage-backed securities, and resulting in a panic among the holders of mortgage-backed securities. Setting aside that national house prices reached an inflection point almost a year before the inflection point in defaults, one measure of the effectiveness of Dodd-Frank's mortgage rules will be to what extent mortgage defaults are reduced.

Table A reproduces select estimates from GAO's analysis of the marginal impact on default probabilities of a standard deviation increase in the variable in question. In most cases, the measure is a dummy variable yielding the impact on default probabilities of change in the dummy. Effects are presented for fixed-rate, long-term ARM, and hybrid ARM loans, all estimates for non-prime purchase loans. Similar impacts (not reported) are found for re-financings.

Marginal Impact on Default Probability

Non-Prime Purchase Mortgage

	Fixed	Long-Term ARM	Hybrid ARM
Loan Amount	1.82	1.59	5.11
HPA: 1st year	-2.05	-2.35	-8.51
HPA: 2nd year difference	1.05	1.26	3.45
DTI > 41%	0.25	0.08	0.59
Full Documentation	-1.08	-1.17	-1.24
CLTV < 80	-0.21	-0.92	-2.42
CLTV 80 to 90	-0.09	-0.39	-1.36
CLTV 90 to 100	0.56	0.56	-0.37
CLTV => 100	1.64	1.18	1.88

Marginal impact from one standard deviation increase in mean.

HPA: House Price Appreciation

DTI: Debt to Income

CLTV: Combined Loan to Value

Source: GAO (2010).

Despite having the largest impact on the number of loans, the proposed QM/QRM restrictions on DTI appear to have very modest impacts on projected defaults. The presence of a DTI in excess of 41 percent increases the probability of default by 0.25, 0.08, and 0.59 for fixed rate, long-term ARM, and hybrid ARM loans, respectively. According to GAO's analysis, reducing the prevalence of mortgages with a DTI in excess of 41 percent will have barely noticeable effects (although statistically significant in all cases).

Restrictions on low- or no-documentation loans do appear to have noticeable impacts on defaults in the subprime market. If all but full documentation loans were used, default probabilities, according to GAO's analysis, would fall by -1.08, -1.17, and -1.24 percentage points for fixed rate, long-term ARM, and Hybrid ARM loans, respectively.

GAO's default analysis predicts substantial declines in defaults from reductions in loan-to-value (LTV), particularly initial moves below a 100 percent closed LTV. For fixed-rate non-prime purchase ▷

loans, moving from a LTV of 100 to under 80 percent reduces projected default probabilities by over three percentage points. For hybrid non-prime ARMs, the reduction in projected default probabilities is just over six percentage points. Coupled with full documentation and a LTV under 80 percent, one could eliminate over 70 percent of the standardized default risk among hybrid non-prime ARMs. Academic studies have arrived at similar conclusions when examining the drivers of default among subprime mortgages.

The approach of Dodd-Frank's mortgage provisions is to focus on loan characteristics, largely ignoring borrower characteristics or housing market impacts. For instance, QM/QRM places no restrictions on borrower credit other than verification. A number of studies, however, find the largest impact on subprime defaults coming from borrower credit, as measured by FICO score. Increasing borrower FICO by one-standard-deviation, or about 74 points, decreases default probability by around seven times as much as switching from an ARM to fixed-rate loan. A 74 point increase in FICO also has over twice the impact of moving from no- or low-documentation to a full documentation loan. Studies also find the impact of housing price changes to be magnitudes higher than the provisions of the QM/QRM rule.

As the down-payment requirements of the proposed QRM rule were abandoned, the remaining changes are likely to have modest impacts on default probabilities. The biggest impact would be from the full documentation requirements and the cap on DTI. These two changes combined, however, are projected to lower default probabilities by around one percentage point.

A study from Professor Morris Kleiner, Humphrey School of Public Affairs, finds that states with more stringent licensing requirements for mortgage brokers actually witnessed higher levels of mortgage default. The hypothesis is that increased barriers to entry reduce underwriting efforts to such an extent that offsets any improvements in broker quality that result from the licensing scheme. Kleiner's results raise the possibility that Dodd-Frank's Section 1401 originator requirements, coupled with the Secure and Fair Enforcement for Mortgage Licensing Act (SAFE Act), actually increase mortgage defaults rather than reduce them, as the statute intends.

The barely noticeable reduction in projected defaults could be more than off-set by Dodd-Frank's impact on the foreclosure process. As noted, Dodd-Frank's Section 1413 allows borrowers an additional delay to the foreclosure process. A longer foreclosure process increases the borrower's incentive to default. New regulations relating to mortgage servicing are likely to extend the ultimate time to foreclosure. Researchers, as well as industry experience, confirm the increase in 'strategic default' during the recent crisis. Dodd-Frank's Section 1414(g) notice on anti-deficiency and the increased delays to foreclosure may well increase strategic defaults more than an amount to off-set reductions resulting from the QM/QRM provisions. Scholars have found that delays in the foreclosure process largely extend the process, raising the overall level of loans in foreclosure at any one time without significantly improving final outcomes for the borrower. Dodd-Frank could very well result in an increase in the level of mortgage defaults during the next housing bust.

CONCLUSIONS

The Dodd-Frank Act institutes the most significant changes to the federal oversight of mortgages in at least 20 years. Much of the details, however, have been left up to financial regulators with the new Consumer Financial Protection Bureau playing a leading role. While the proposed Qualified Mortgage and Qualified Residential Mortgage rules will likely increase the cost of mortgage credit, particularly due to increased litigation, compliance, and foreclosure costs, their impacts on reducing foreclosures during the next housing bust are likely to be modest and may even increase foreclosures. Despite the significant changes to the mortgage market under Dodd-Frank, those features of the American mortgage market most relevant to the financial crisis, such as lack of market discipline, remain unaddressed and, in many cases, have been made worse. MCM

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