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MORTGAGE REFORM UNDER THE DODD-FRANK ACT

MARK A. CALABRIA
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Mark Calabria

Many, if not most, accounts of the financial crisis of 2008 include a prominent role for the U.S. residential mortgage market. While other U.S. property markets, such as commercial and retail, exhibited similar boom and bust patterns, the elevated level of defaults and associated costs borne by the taxpayer have brought a particular emphasis on American single-family mortgage finance policies. It should be of little surprise that the Dodd-Frank Act contains multiple provisions related to mortgage finance. This paper offers a review of those provisions, followed by an evaluation of their likely impact and effectiveness.

Significant Mortgage Provisions

Dodd-Frank's sixteen separate titles contain a number of provisions impacting the mortgage market. The financial services law firm Davis Polk estimates that Dodd-Frank will require 49 separate rule-makings in the area of mortgage reform alone. Of particular importance are those found in titles IX, X and XIV. These three titles have the most direct impact on the mortgage market and will be the focus of this paper.

Many other provisions indirectly affect the mortgage market. By way of example, the financial stability provisions of title I could have dramatic impacts

on competition in the mortgage market. Before divesting its depository subsidiary, MetLife had established a business plan to become a top 5 national mortgage originator. In order to avoid a systemic designation under Dodd-Frank's title I, MetLife abandoned those plans. MetLife's abandonment of the mortgage market has left mortgage origination less competitive than it would be otherwise. However, these provisions are outside the scope of this review. In general this paper will focus on the more direct impacts.

SKIN IN THE GAME

One of the more interesting approaches to risk management is 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 5 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 (QRM) that is to be determined by regulations jointly issued by the federal financial regulators, along with the Department of Housing and Urban Development and the Securities and Exchange Commission. 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 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, 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. While initial versions of the QRM have exempted Fannie Mae and Freddie Mac loans, as long as those entities are in conservatorship, the Federal Housing Finance Agency has chosen to restrict Fannie Mae and Freddie Mac to the purchase of QRM compliant mortgages. A concern is that such exemptions would further entrench the federal government's current dominant role in the mortgage market, leaving taxpayers vulnerable to additional losses and distorting the pricing and allocation of risk within the broader mortgage market.

By construction, mortgages held in portfolio would be exempt from the QRM requirements. An open question is to what extent 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.

An initial QRM proposed rule was issued by regulators on April 29, 2011. In this initial rule regulators fleshed out a number of characteristics “that have been demonstrated to exhibit a higher risk of borrower default.” The most controversial of these has been a minimum 20 percent required down-payment. While there is little, if any debate, over the contribution of lower down-payments to default behavior, comments submitted to the regulators, from financial firms and advocacy groups, claim that such a requirement would dramatically reduce mortgage access to low income and minority households. Commentators have also observed that Dodd-Frank’s Section 941 is silent on the issue of down-payment. In response regulators issued a new proposed rule on August 28, 2013. The new proposal solicits comments on either no down-payment requirement or a higher 30 percent requirement, dropping the original 20 percent requirement. It is widely expected that commentators will support the elimination of any down-payment requirement and that regulators will accordingly offer a final rule with no limitations on loan-to-value.

Also of interest are the QRM's requirements for debt-to-income ratios. The initial rule sets a maximum front-end ratio of 28% and a back-end ratio of 36%, which are consistent with the ratios generally observed in the conventional mortgage market although stricter than those observed in FHA.

The final QRM rule will possess the potential to dramatically shape the characteristics of which loans may or may not be sold into the public secondary markets. As the QRM is also an amendment to the 1934 Act, 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.

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 title 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 theme of the pre-Dodd-Frank efforts at mortgage reform has been the focus on mortgage brokers versus lenders. Since their rise from the ashes of the Savings and Loan Crisis, mortgage brokers grew to become a significant share of mortgage originations. For a variety of reasons, including their lack of established reputation and focus on performance-based compensation, brokers were often assigned responsibility for poor underwriting decisions made in the years leading to the crisis. Congress reacted to such concerns in 2008 by including the Secure and Fair Enforcement for Mortgage Licensing Act (“SAFE Act”) as title V of the Housing and Economic Recovery Act of 2008.

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.

Table 1

Dodd-Frank’s Section 1401 expands the definition of “mortgage originator” while also adding new requirements for persons falling under such definition. A “mortgage originator” under Section 1401 is defined to be a person “who, for direct or indirect compensation or gain, or in the expectation of direct or indirect compensation or gain – (i) takes a residential mortgage loan application; (ii) assists a consumer in obtaining or applying to obtain a residential mortgage loan; or (iii) offers or negotiates terms of a residential mortgage loan.” Although

the Act contains exceptions to this definition, the impact will mean that all mortgage brokers and many bank employees, other than administrative and clerical, will be considered mortgage originators and hence subject to both enforcement and litigation risk.

Once one falls under the “mortgage originator” definition a variety of duties and restrictions apply, including the requirement to be qualified and licensed under the “SAFE Act”. Dodd-Frank also prohibits the compensation of originators varying based upon the terms of the loans, other than based on the principal amount. Originators may only receive compensation from a party other than the borrower in instances where the borrower pays nothing to the originator as well as not paying any upfront fees or points. Originators can, however, continue to be compensated on the volume of loans closed. The intent of these restrictions is to limit the incentive of originators to place borrowers in higher cost loans.

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 under which the borrower lacks a reasonable ability to pay or that have certain features. 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 are found in Section 1411’s “ability to pay” requirements. Section 1411 prohibits lenders from making 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,” most details are left to the CFPB. Even under the currently-proposed ability-to-pay rule, considerable discretion remains in interpreting these terms. Due to concerns over the lack of clarity in the ability-to-pay standard, Dodd-Frank’s Section 1412 allows for the creation of a safe harbor from liability if lenders 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.

Lender compliance with the “ability to pay” requirements are 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. Ultimately these compliance costs will be passed along to borrowers, mostly likely in the form of higher rate spreads.

Similar to the QRM, 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 ARMs, 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. The CFPB is to establish maximum debt to income ratios for qualified mortgages as well.

Dodd-Frank's title XIV contains additional prohibitions that go beyond its ability-to-pay 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, lenders are prohibited from requiring mandatory arbitration for all residential mortgages. Even if such 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 HOEPA are part.

Title X of Dodd-Frank creates the Consumer Financial Protection Bureau (CFPB). Enforcement and implementation of most pre-existing mortgage regulation, including that under the Truth in Lending Act, the SAFE Act and the Real Estate Settlement Procedures Act, transfers to the CFPB. This new agency is given considerable authority to re-write existing rules, as well as given responsibility for policing unfair and deceptive practices in the mortgage market. Dodd-Frank also adds a new category of “abusive” practices, yet to be defined by the CFPB. Whereas HUD and the Federal Reserve were the primary federal regulators in the area of mortgage finance, CFPB will now take their place. There is a strong expectation that CFPB will be a more aggressive regulator than was either HUD or the Federal Reserve.

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

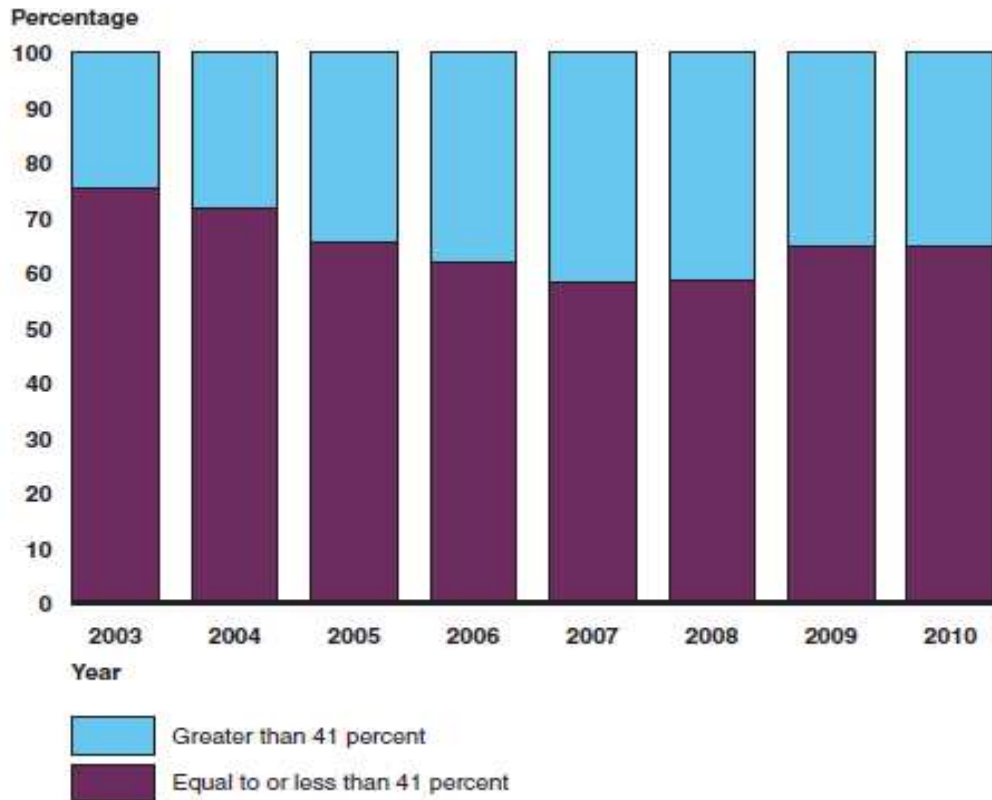
Federal Housing Finance Agency (FHFA) and the private firm CoreLogic. GAO's analysis is based predominately on CoreLogic data, so unsurprisingly their conclusions are similar. FHFA's analysis is based upon its collection of Fannie Mae and Freddie Mac mortgage data. None of these studies attempt to incorporate 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 impacts of QRM. The most restrictive provision of the proposed QRM rule would be the ceiling on allowable debt-to-income ratios (DTI). The initial proposal included a cap of debt-to-income of 28 percent for the front-end ratio and 36 percent for the back-end ratio. At the time of this writing, press reports indicate a loosening of this standard. The final QRM rule is likely to have a back-end ratio of either 41 or 42 percent, which is consistent with the requirements under FHA.

Figure 1, reproduced from GAO's analysis shows the proportion of prime, near-prime and government-insured mortgages by over or under a 41 percent DTI. At one extreme, almost 40 percent of these mortgages displayed DTI above 41 percent in 2007 and 2008. In a more "normal" market environment of say 2004,

the percentage was just under 30 percent. Many borrowers, however, are likely to have only reported sufficient income to meet the loan requirements. Of course other borrowers might have “over-reported” income. Either would change the magnitude of this impact. A reasonable approximation is somewhere around 25 percent of mortgages will be non-QRM compliant due to the DTI restrictions. Dodd-Frank’s Section 941 does not require a specific DTI, but it does require a DTI test, leaving regulator’s little room to ignore this constraint.

Previous GAO analysis has indicated about between 2000 and 2007, the percent of subprime loans with a DTI in excess of 41 ranged between 47.1 percent in 2000 to 59.3 percent in 2007. This will likely be the most significant impact of the final QRM rule: a very large reduction in the percentage of subprime loans that are QRM eligible due to limitations on DTI. Of course these loans can still be placed into a MBS as long as there is sufficient risk retention. Non-QRM loans can also be held on portfolio.



Source: GAO analysis of CoreLogic data.

Figure 1

A number of QRM restrictions are likely to have very modest impacts, as their prevalence in the mortgage market was generally low. Both the proposed 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 9 percent. The average between 2001 and 2010 was closer to 1 percent. 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 then 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 4 percent 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 re-finance 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. It may also signal the end, or at least a long pause, in the decades long push to extend

maturity as an avenue for increasing “affordability”. There is some irony in the federal government historically leading the charge to extend maturity now taking the position that mortgage maturities should be no more than 30 years.

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. As with long maturity mortgages, balloon payments appeared as last ditch efforts to get into the booming housing market. Their disappearance could constrain affordability during a boom, which is not necessarily a bad thing, but Dodd-Frank balloon restrictions are likely to have an insignificant impact on the mortgage 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. According the option of simply holding no- or low-documentation loans on portfolio is not likely to be an attractive option for lenders. 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 percent 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. Most lenders have significant experience documenting loans for the self-employed, so the extent to which these requirements reduce mortgage availability remains open. Most lenders are likely to reduce their risk on self-employed mortgages by requiring higher downpayments and credit scores. Self-employed borrowers with subprime credit are likely to see the greatest reduction in mortgage availability under Dodd-Frank's documentation requirements.

The most controversial element of the proposed QRM rule is the minimum downpayment requirement. As proposed, for a mortgage to be QRM compliant would require a minimum downpayment of 20 percent for home purchase, 25 percent for a standard re-finance, and 30 percent for a cash-out re-finance. There

are no downpayment requirements for the proposed QM rule and the downpayment requirements proposed under QRM are within the discretion of regulators and not required by the statutory language of Dodd-Frank.

The impact of a minimum downpayment requirement is perhaps the hardest to measure of the Dodd-Frank restrictions. GAO estimates that 22 percent of mortgages originated in 2006 had a LTV in excess of 80 percent. For the same cohort, 11 percent had a LTV in excess of 90 percent. These figures only tell us how much of a downpayment borrowers made, not how much they could have made. Without extensive data on borrower wealth, it is hard to gauge if borrowers could have afforded increased downpayment requirements. The Wilson and Callis (2013), using the Survey of Income and Program Participation, estimate that moving from a zero to 5 percent downpayment would eliminate 1.3 percent of renters from being able to purchase a “modestly priced” home. Obviously a 20 percent downpayment would have a larger impact. Given FHA’s exemption from the QRM rule, borrowers should still seek a low-downpayment alternative via FHA and of course lenders could either hold low-downpayment loans on portfolio or meet the required risk retention levels of the QRM rule. Increased downpayment requirements could also be off-set with house price declines. Hatchondo, Martinez and Sanchez (2011) estimate that in the absence of house price declines, a 15 percent downpayment requirement would reduce

homeownership rates by only 0.2 percentage points and that a house price reduction of 0.7 percent would result in no decline in homeownership rates.

Loans that do not meet the QRM requirements can still be securitized, with the caveat that the issuers must retain not less than 5 percent of the credit risk of the securitized asset pool. Issuers are also prohibited from hedging or otherwise transferring this risk. The proposed QRM rule, which was re-issued for comment on August 28, 2013, offers a number of options for determining the 5 percent retention. The most obvious would be a 5 percent “first-loss” where the issuer bears the first 5 percent of loss. Other options include a 5 percent prorated share of total losses, in which issuers retained 5 percent of each class of ABS under the transaction, or a so-called “vertical” risk retention. Only in cases of 100 percent loss would such equal the 5 percent first loss framework. Questions have also been raised as to whether risk retention should be calculated on a fair value basis. While regulators could ultimately go above 5 percent retention, such appears unlikely. 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.

Press reports at the time of the August 2013 re-issue indicate that regulators may abandon any downpayment requirement for the QRM and harmonize the QRM rule to mirror the QM. Dodd-Frank requires regulators to establish a QRM standard that is “no broader” than the QM standard. This is some question as to whether “broader” means that the set of QRM complaint

loans is greater or smaller than the set of QM compliant loans. At least one legal expert (Natter 2012) has argued that “broader” eliminates the ability of regulators “to have a more inclusive definition of QRM” than of QM. In all likelihood regulators will solve this issue by having a QRM and QM rule that are largely mirrors, in terms of loans eligible. Such would result in having no minimum downpayment requirements.

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, 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 does it reduce mortgage defaults.

Table 2 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, 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).

Table 2

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, respectively. Accordingly to GAO’s analysis, reducing the prevalence of mortgages with a DTI in excess of 41 will have barely notice 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, respectively.

Although the finality of the QRM's downpayment requirements are in question, GAO's default analysis predicts substantial declines in defaults from reductions in 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 3 percentage points. For hybrid non-prime ARMs, the reduction in projected default probabilities is just over 6 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. CoreLogic estimates that the proposed QM and QRM rules would "remove 60 percent of loans [and] more than 90 percent of the risk." Again CoreLogic does not incorporate behavioral changes and does not calculate impact on portfolio-held loans

Bajari, Chu and Park (2010) arrive at similar conclusions when examining the drivers of default among subprime mortgages, with the exception of finding a larger impact from DTI than does GAO.

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. Bajari, Chu and Park (2010) for instance 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, decreasing default probability by around seven times as much as switching from an ARM to fixed rate. A 74 point increase in FICO also has over twice the impact of moving from a no/low to full documentation low. Both GAO and Bajari, Chu and Park also find the impact of housing price changes to be magnitudes higher than the provisions of the QM/QRM rule.

If the down-payment requirements of the proposed QRM rule are 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 1 percentage point.

Kleiner (2009) 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 off-sets 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 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. The CFPB has also issued new regulations relating to mortgage servicing that are likely to extend the ultimate time to foreclosure. Keys, Piskorski, Seru and Vig (2012) document 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. As Gerardi, Lambie-Hanson, and Willen (2011) have demonstrated, 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.

SINS OF OMISSION

Dodd-Frank contains the most sweeping changes to mortgage regulation since at least the slate of Congressional activity in the aftermath of the Savings and Loan

Crisis. With various sections and as many as 49 separate rule-makings, it would be easy to assume that everything worth covering in the mortgage market is covered. Yet Dodd-Frank leaves the basic structure of our mortgage finance system in place. The failures of Fannie Mae and Freddie Mac are addressed by Dodd-Frank in the form of a “study”, which has subsequently been released by the Treasury Department.

The various forms of moral hazard in the mortgage market, resulting from various government guarantees, remains, and if anything is stronger than before the crisis. The various federal efforts to extend credit, such as the Community Reinvestment Act (CRA) and Home Mortgage Disclosure Act (HMDA), have not been reformed. Steinbuks and Elliehausen (2013) suggest that the impact of Dodd-Frank’s mortgage restrictions will be to greatly reduce subprime credit. After the enactment of North Carolina’s predatory lending law, Steinbuks and Elliehausen estimate that subprime originations declined over 20 percent. Yet federal regulators and politicians are unlikely to simply sit and watch this restriction of credit, particularly this reduction is not felt evenly across racial groups. An open question will be to what extent regulators will leverage CRA and HMDA to pressure banks to continue making loans to borrowers with subprime credit. A possible outcome of Dodd-Frank’s mortgage reforms is a reduction in the use of risk-based pricing. The only certainty appears to be continued uncertainty and tension in the federal regulation of mortgage finance.

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 increase 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 in Dodd-Frank to the mortgage market, 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.

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