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Qualified Residential Mortgage Regulations Threaten the Housing Market

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The housing market is still weak,[1] and federal regulators are considering a regulation that could make matters even worse. Known as the Qualified Residential Mortgage (QRM) rule, the draft rule could have the effect of requiring many home buyers to have at least a 20 percent down payment in order to qualify for a best interest rate mortgage. [2] In addition to making it harder for qualified consumers to obtain loans, the proposed regulation would preserve the roles of Fannie Mae and Freddie Mac, the government-sponsored finance agencies whose collapse has already cost taxpayers in excess of $150 billion. It would also further concentrate mortgage lending in the largest financial institutions.

Skin in the Game. The QRM is part of a risk-sharing provision in the Dodd–Frank financial regulation bill that was supposed to require lenders to do a better job of underwriting mortgages. Under the old system, lenders and brokers received a fee for writing a loan and another fee for selling it to underwriters, who included it in mortgage-backed securities. Since their income came from the fees, these brokers and lenders had no further interest in the loan and found they could maximize their income by making dozens of loans, regardless of whether the borrowers had any ability to repay the mortgages. The flood of bad mortgages caused billions of dollars in losses to homeowners, lenders, and investors.

Congress responded by including a risk-retention rule that would require the creators of mortgage-backed securities to retain 5 percent of the pool. Since they would share in any losses, legislators felt that this would encourage securitizers to ensure that the mortgages they buy meet good credit standards. As a further incentive to quality underwriting, securitizers would not be required to retain a 5 percent share of securities that meet specific minimum credit standards defined in the QRM regulations.

As the mortgage disaster illustrated, better underwriting is an absolutely essential step toward both housing recovery and a restoration of faith in mortgage-backed securities. However, it is very unlikely that the Dodd–Frank provision would have the effect that supporters expect.

Disqualifying 75 Percent of Buyers. The proposed regulations define "qualified residential mortgages" as those with a loan-to-equity ratio of 80 percent or less for home purchasers, 75 percent for refinancing, and 70 percent for refinancing where the homeowner receives cash as a result of the transaction.[3] In addition, prospective purchasers would need a very clean credit history. In order to meet this standard, a purchaser would either have to have a 20 percent down payment or that amount in equity from a previous home. Refinanc-

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ers would need even more cash or equity. This is utterly at odds with the realities of today's housing market, where in 2010 only 16 percent of first-time buyers and 37 percent of repeat buyers would have qualified for QRM status.[4] Counting both groups together, fully 75 percent of 2010 home buyers would not have qualified for this quality of loan.

These numbers are doubly significant for the recovery of housing since many home owners have seen the value of their property drop precipitously over the past few years and may not have much, if any, equity left. While failure to qualify for QRM status may not prevent consumers from obtaining a mortgage, it would force them to pay higher interest rates on the mortgages they do obtain. For current home owners, having to pay higher mortgage interest rates would, in turn, reduce the value of the house they can afford, which could put additional downward pressure on housing prices.

Preserving Fannie Mae and Freddie Mac and Expanding FHA. Contrary to the stated goal of the Obama Administration and many in Congress of eliminating Fannie Mae and Freddie Mac,[5] the draft regulations exempt both those entities and the Federal Housing Administration (FHA) from the requirement to retain a 5 percent stake in mortgage pools that are converted into securities.

Thus, at the very time that Congress is considering bills[6] to reduce the advantages the two housing giants have in order to encourage private-sector competitors to begin to take over Fannie Mae and Freddie Mac's functions, regulators are seeking to give them another advantage. Not having to retain a 5 percent interest in their mortgage-backed securities will allow Fannie Mae and Freddie Mac a significant cost advantage over potential private-sector rivals, enable them to securitize any grade of mortgage without penalty, and undermine efforts to improve the quality of mortgages. Sadly, prior to 2007, both housing giants showed serious weaknesses in securitizing poor-quality mortgages and buying investment securities containing poor-quality mortgages. There is little reason to expect them to do better now.

Exempting FHA from the risk retention rules will also distort housing markets. Since FHA requires only a 3.5 percent down payment, its cost advantage over private-sector entities that would have to retain a 5 percent interest in mortgages would allow it to dominate the housing market for non-QRM loans.

Driving Smaller Institutions out of Business. Even if the 20 percent down payment requirement and the exemptions for Fannie Mae, Freddie Mac, and the FHA were eliminated, the risk-retention rule is likely to have a negative effect on private securitizers other than large banks. Because the 5 percent retention will be for a lengthy period of time, only larger, well-capitalized entities will be able to meet this requirement. Smaller entities or thinly capitalized non-bank mortgage lenders will not be able to afford it.

Serious Rethinking Is Necessary. While well-intentioned, the draft Qualified Residential Mortgage regulations would have serious negative consequences for individual borrowers and for

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1. Jeffry Bartash, "Construction of New Homes Falls in April," *MarketWatch,* May 17, 2011, at *http://www.marketwatch.com/story/construction-of-new-homes-fall-in-april-2011-05-17* (May 24, 2011).
2. Proposed Regulation, "Credit Risk Retention," Federal Deposit Insurance Corporation (FDIC), at *http://www.fdic.gov/news/board/29Marchno2.pdf* (May 25, 2011).
3. In addition, the draft regulations require the borrower to have enough cash to cover all closing costs; have not had a delinquent payment late by 60 days or more for the past 24 months; and not spend more than 27 percent of total income on housing-related expenses or more than 36 percent of income on debt repayment.
4. National Association of Realtors, "Profile of Home Buyers and Sellers 2010," p. 71.
5. David C. John, "End Fannie Mae and Freddie Mac to Build Tomorrow's Housing Finance System," Heritage Foundation *WebMemo* No. 3147, February 10, 2011, at *http://www.heritage.org/Research/Reports/2011/02/End-Fannie-Mae-and-Freddie-Mac-to-Build-Tomorrows-Housing-Finance-System*.
6. David C. John, "Two Promising Starts towards Ending Fannie Mae and Freddie Mac," Heritage Foundation *Foundry*, March 31, 2011, at *http://blog.heritage.org/2011/03/31/two-promising-starts-towards-ending-fannie-mae-and-freddie-mac.*

efforts to reform the housing market by eliminating Fannie Mae and Freddie Mac. This appears to be yet another example of overloaded regulators producing draft regulations without considering major issues and weighing their consequences. Rather than rushing into final regulations, the regulators should take the time to fully understand the issues and to extensively revise the draft QRM regulations.

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