The Heritage Foundation
LEADERSHIP FOR AMERICA

BACKGROUNDER

No. 2866 | DECEMBER 16, 2013

Dodd–Frank Mortgage Rules Unleash Predatory Regulators

Diane Katz

Abstract
Radical new regulation of mortgage financing will take effect on January 10, 2014. Washington's hastily crafted response to the financial crisis is built on the belief that the housing bubble and subsequent crash were the fault of unscrupulous mortgage lenders who took advantage of naive, uninformed consumers. In reality, lenders and borrowers were responding rationally to incentives created by an array of deeply flawed government policies. None of those major factors is addressed by the new regulatory regime. Congress instead opted to further empower the very establishment that fueled the crisis and then failed to contain it. Consequently, the new rules will unnecessarily limit mortgage options and access to credit, and thus further erode Americans' freedom.

Extensive new federal regulation of mortgage lenders and homebuyers is slated to kick in on January 10.[1] Virtually every aspect of financing a home—including mortgage options, eligibility standards, and even the structure and schedule of payments—will be governed by regulations peddled as preventing another collapse of the housing market. However, this new regime is based on faulty notions about the causes of the crash. Consequently, the government will be unnecessarily limiting financing options and access to credit, and thus further expanding control over Americans' lives.

The 3,500-plus pages of looming rules are the product of the Dodd–Frank Wall Street Reform and Consumer Protection Act, Washington's hastily crafted response to the financial crisis. Most

Key Points

- The cornerstone of the Dodd–Frank Act is a lender obligation to determine that a borrower has the "ability to repay" the loan. This shift of accountability perverts credit principles, and presumes that consumers are incapable of acting in their own interests.
- The "ability-to-repay" regime is the basis of an expansive new consumer right to sue lenders for miscalculating their financial fitness for a loan. The obvious consequence will be more litigation and less credit availability.
- Officials suggest that lenders look to entities such as the Federal Housing Administration for guidance on underwriting—the very agency that racked up a $16 billion deficit to its insurance fund last year, and which has requested a taxpayer bailout.
- Dodd–Frank offers a "safe harbor" from potential ability-to-repay litigation through a "qualified mortgage"—whose restrictive criteria will increase the number of applicants rejected for loans and create a barrier to the wealth creation associated with property investment.

This paper, in its entirety, can be found at **http://report.heritage.org/bg2866**
Produced by the Thomas A. Roe Institute for Economic Policy Studies

The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002
(202) 546-4400 | heritage.org

Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

notable among them is a new requirement imposed on lenders to ensure that borrowers have the "ability to repay" a mortgage. In turn, borrowers gain a new right to sue lenders for misjudging their financial fitness. Dozens of new rules also dictate procedures for appraisals and escrow accounts, title agents and loan originators, as well as edicts on the precise timing and content of communications between lenders and borrowers, the format of periodic statements, and borrowers' new rights in foreclosure proceedings, among hundreds of other commandments.

These and many of the other regulations unleashed by Dodd–Frank (as well as those that were not) are a response to a politicized storyline of the housing bubble and its subsequent bust. This phony narrative casts the blame on "predatory" lenders and greedy Wall Street investors who exploited financially illiterate consumers.

Reckless lending did play a role in the crisis, but the reality is that millions of lenders and borrowers were responding rationally to incentives created by an array of deeply flawed government policies, including artificially low interest rates contrived by the Federal Reserve, the massive subsidy of risky loans by Fannie Mae and Freddie Mac,[2] and the low-income lending quotas set by the Department of Housing and Urban Development.[3] None of those major factors was addressed by Dodd–Frank; Congress instead opted to further empower the very regulatory establishment that fueled the crisis and then failed to contain it.

Management of the new mortgage scheme is centralized in Dodd–Frank's new Consumer Financial Protection Bureau (CFPB), one of the most powerful—and unaccountable—federal agencies ever created.[4] Although established within the Federal Reserve System, the CFPB operates independently, and with virtually no oversight by Congress or the White House.[5] Authorized to regulate nearly every consumer financial product and service, it is the epitome of the regulatory state run amok.

Management of the new mortgage scheme is centralized in Dodd–Frank's new Consumer Financial Protection Bureau, one of the most powerful—and unaccountable—federal agencies ever created.

Crisis legislation such as Dodd–Frank is rarely, if ever, elegant. But the blanket restructuring of housing finance confuses government control with financial safety and soundness. That is a mistake Congress must correct if consumers are to have mortgage options and the housing market any hope of recovery. The most effective remedy is to eliminate the government policies that distorted the financial decisions of both lenders and borrowers, with such disastrous results.

Status of the Housing Market

The U.S. housing market collapsed between 2006 and 2008. The dollar value of mortgage originations for single-family houses fell by half during that period,[6] while the delinquency rate increased by 50 percent and the foreclosure rate increased by 175

1. See the appendix for all mortgage regulations issued by the Consumer Financial Protection Bureau (CFPB).
2. Fannie Mae (the Federal National Mortgage Association) and Freddie Mac (the Federal Home Loan Mortgage Corporation) are corporations authorized by Congress to buy mortgages from lenders and pool loans to sell as securities to provide liquidity for lenders.
3. Comprehensive analyses of the financial crisis include Christopher L. Foote, Kristopher S. Gerardi, and Paul S. Willen, "Why Did So Many People Make So Many Ex Post Bad Decisions? The Causes of the Foreclosure Crisis," Federal Reserve Bank of Atlanta, *Working Paper* No. 2012-7, May 2012, http://www.frbatlanta.org/documents/pubs/wp/wp1207.pdf (accessed November 21, 2013); John A. Allison, *The Financial Crisis and the Free Market Cure* (New York: McGraw Hill, 2012); and Peter J. Wallison, *Bad History, Worse Policy: How a False Narrative about the Financial Crisis Led to the Dodd–Frank Act* (Washington, DC: AEI Press, 2013).
4. Prior to passage of Dodd–Frank, authority for some 50 rules and orders stemming from 18 consumer-protection laws was divided among seven agencies.
5. For an overview of bureau operations, see Diane Katz, "The CFPB in Action: Consumer Bureau Harms Those It Claims to Protect," Heritage Foundation *Backgrounder* No. 2760, January 22, 2013, http://thf_media.s3.amazonaws.com/2013/pdf/bg2760.pdf.
6. Federal Housing Finance Agency, "Market Data: Single-Family Mortgage Originations, 1990–2011 Q2," revised November 2, 2011, http://www.fhfa.gov/Default.aspx?Page=70 (accessed November 25, 2013).

percent.[7] The attendant losses to mortgage-backed securities triggered the major recession from which the nation has yet to fully recover.

The free fall ended in 2009, when home sales and construction registered the first upticks in years. But the backlog of foreclosures depressed home prices until 2012. According to the Trulia Housing Barometer, which tracks housing trends, the market is now 64 percent back to normal, compared with just 36 percent one year ago.[8] Construction and existing home sales gradually increased, while the rates of delinquency and foreclosure declined. However, interest rates have inched up in recent months, which has reduced mortgage refinancing and is prompting banks to lay off hundreds of loan officers. Pending home sales also declined in September, for the fourth consecutive month, according to the National Association of Realtors.[9]

Although demand for housing revived somewhat, credit has remained exceedingly tight. Loan origination currently hovers around an annual rate of $500 billion (it was $1.5 trillion before the housing crash).[10] Among the home sales that have occurred, some 45 percent of the mortgages are associated with the Department of Veterans Affairs (VA) and the Federal Housing Administration (FHA).[11] (An FHA-insured loan requires a down payment of just 3.5 percent; a VA-insured loan, none.[12])

Widespread caution among lenders and borrowers was inevitable after the crash. The loose underwriting standards that dominated the industry have largely been abandoned.[13] According to CoreLogic's TrueStandings Servicing, a proprietary data service, the Fair Isaac Corporation (FICO)[14] score of mortgage borrowers in the first nine months of 2012 (weighted average) was 750, compared to 706 in 2007[15]; the loan-to-value ratio was 78 percent, down from 80 percent; and the debt-to-income (DTI) ratio was 34.5 percent, down from 39.8 percent. In other words, lenders are taking far fewer mortgage risks. Indeed, more than half of all homes sold last year and so far in 2013 have been cash transactions—compared to 20 percent without a mortgage before the crash, according to economists at the Goldman Sachs Group.[16]

The protracted rollout of hundreds of new financial services regulations is also a factor. Much of Dodd–Frank was crafted in general terms, leaving regulatory agencies considerable discretion in writing the rules. Lenders have been understandably cautious in light of the uncertainty about the regulatory details and the escalating compliance costs.

In testimony before a subcommittee of the House Financial Services Committee, First United Bank and Trust CEO William B. Grant estimated conservatively that Dodd–Frank would impose compli-

7. For one-family to four-family residences. U.S. Census Bureau, "Table 1193. Mortgage Originations and Delinquency and Foreclosure Rates: 1990 to 2009," http://www.census.gov/compendia/statab/2011/tables/11s1193.pdf (accessed December 3, 2013).
8. Jed Kolko, "Housing Recovery in Phase Three: Market 64% Back to Normal," Trulia Trends, August 27, 2013, http://trends.truliablog.com/2013/08/housing-barometer-july-2013/ (accessed November 21, 2013).
9. National Association of Realtors, "Pending Home Sales Continue Slide in September," October 28, 2013, http://www.realtor.org/news-releases/2013/10/pending-home-sales-continue-slide-in-september (accessed November 21, 2013).
10. Nick Timiraos, "Half of All Homes Are Being Purchased with Cash," *The Wall Street Journal*, August 15, 2013.
11. Nick Timiraos, "Eight Takeways on Mortgages After the Housing Bust," *The Wall Street Journal*, September 23, 2013.
12. FHA Info, "How Much Money Do I Need for an FHA Loan?" 2012, http://www.fhainfo.com/howmuchmoney.htm, (accessed November 25, 2013), and U.S. Department of Veterans Affairs, "Home Loans," http://benefits.va.gov/homeloans/index.asp (accessed November 25, 2013).
13. The standards eased in response to expectations of rising house prices as well as the willingness of Fannie Mae and Freddie Mac to invest heavily in subprime loans. As noted by Foote et al., "Zero-down loans, subprime mortgages, negative amortization, and reduced documentation all make sense if prices are expected to grow rapidly, since it is the value of the house—not the borrower's income—that guarantees repayment of the loan."
14. FICO represents various factors calculated to determine credit risk, including payment history, current level of indebtedness, types of credit used, length of credit history, and new credit.
15. For consumers that have received closed-end first-lien mortgages. "Bureau of Consumer Financial Protection, Ability-to-Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z), Final rule," *Federal Register*, Vol. 78, No. 20, January 30, 2013, http://www.gpo.gov/fdsys/pkg/FR-2013-01-30/pdf/2013-00736.pdf (accessed November 21, 2013).
16. Timiraos, "Half of All Homes Are Being Purchased with Cash."

ance costs of about $50 billion annually, or about 12 percent of total operating expenses.[17] Such costs are inevitably paid by consumers in the form of higher service fees or fewer product choices. But the direct expenses are just part of the story, Grant noted:

> Instead of teaching staff to reach out to new markets, trainers are bringing the employees up to speed on the latest regulations. Instead of money being used to make loans to hardworking people and businesses in our communities, it is being spent on consultants, lawyers, and auditors. Instead of investing precious capital into new products to meet the ever-changing demands of our customers, banks are paying for changes to software to assure compliance with all the new changes.

Lenders also are more restrained in the wake of several multibillion dollar "settlements" with the government over alleged violations of loan processing and foreclosure procedures.

CFPB officials say they are "sensitive" to the potential impact of the new mortgage rules on a housing market recovery.[18] But the bureau failed to undertake empirical analyses of the effects of the rules, and officials claim that the impacts are beyond their control, dependent on "economic cycles, market developments, and business and consumer choices that are substantially independent from adoption of the rule."[19] In classic bureaucratic fashion, officials are touting their regulatory accomplishments while distancing themselves from the costs.

Ability-to-Repay Rule

The cornerstone of the mortgage regulations finalized on January 30 by the CFPB is a lender obligation to "make a reasonable and good faith determination based on verified and documented information that the consumer has a reasonable ability to repay the loan according to its terms."[20] This ability-to-repay provision is more than a procedural requirement. It is the basis of an expansive new consumer right to sue lenders for miscalculating their financial fitness for a loan.

In classic bureaucratic fashion, officials are touting their regulatory accomplishments while distancing themselves from the costs.

Under the new regime, a borrower may sue a lender within three years of an alleged violation, such as improperly documenting income or assets, or incorrectly calculating the borrower's financial obligations. Those who prevail may recover damages equal to the sum of all finance charges and fees paid—potentially tens of thousands of dollars.

A borrower may also assert a violation of the ability-to-repay requirement as a defense against foreclosure—even if the original lender sold the mortgage or assigned it to a servicing firm. (The lawsuit may ensnare an assignee or holder of the mortgage, as well.) If successful, the borrower may recover all mortgage finance charges and fees paid[21] in addition to actual damages; damages in an individual action or class action; and court costs and attorney fees.

The obvious consequence of this new cause of action will be more litigation and less credit availability. No longer will borrowers who wish to contest foreclosure have to initiate a lawsuit against the lender. This will reduce borrowers' legal costs and thus increase the incentive to claim a violation of the ability-to-repay requirement in the event mortgage payments become burdensome. A new prohi-

17. "Testimony of William B. Grant on Behalf of the American Bankers Association before the Subcommittee on Financial Institutions and Consumer Credit of the [House] Committee on Financial Services," American Bankers Association, May 9, 2012, http://www.aba.com/aba/documents/press/TestimonyBillGrantHFSCostofCompliance.pdf (accessed November 21, 2013).
18. "Consumer Financial Protection Bureau, Ability-to-Repay and Qualified Mortgage Standards Under the Truth in Lending Act," *Federal Register*.
19. Consumer Financial Protection Bureau, "Report Under 5 U.S.C. § 801(a)(2)(A) on a Major Rule," March 4, 2013, http://www.cfpbmonitor.com/files/2013/03/2013-03-11-Mortgage-Servicing-Rules-Under-the-Real-Estate-Settlement-Procedures-Act-Regulation-X.pdf (accessed November 21, 2013).
20. "Consumer Financial Protection Bureau, Ability-to-Repay and Qualified Mortgage Standards Under the Truth in Lending Act," *Federal Register*. The requirement is waived for the FHA and other government agencies.
21. In a foreclosure that occurs three or more years after loan consummation, borrowers would be reimbursed for 36 months of interest.

bition on pre-dispute arbitration also is expected to "dramatically increase the litigating of disputes which would have otherwise been resolved by arbitration."[22]

The new rules reflect the notion that dastardly creditors and lax lending standards led consumers to assume mortgages they could not afford. However, in the context of the rising house prices at the time, higher-leveraged loans made financial sense. As explained by Federal Reserve Bank researchers,

> If [lenders and borrowers] believe that house prices would continue to rise rapidly for the foreseeable future, then it is not surprising to find borrowers stretching to buy the biggest houses they could and investors lining up to give them the money. Rising house prices generate large capital gains for home purchasers. They also raise the value of the collateral backing mortgages, and thus reduce or eliminate credit loses for lenders.[23]

The new rules also reflect the low regard in which Americans are held by Congress and the CFPB bureaucrats. Under the ability-to-repay regime, lawmakers shifted accountability for loans from borrowers to lenders. This perversion of credit principles presumes that consumers are incapable of acting in their own interests. Even assuming the most benevolent intentions, such paternalism fosters dependence on government and erodes economic freedom.

Advocates attempt to justify this radical change by citing statistics on the wave of defaults and foreclosures during the housing crash. While many homeowners did incur terrible losses, most were not victims of predatory lending or fraud. The hard truth is that most of them bet on rising home values and lost. They were not imbeciles. And not one person will be made whole by the government abolishing credit options and curtailing financial freedom.

Even CFPB officials acknowledge that the new rules will raise the costs and risks of mortgage lending. Creditors must reconfigure policies and procedures, reprogram loan origination systems, and retrain personnel—thereby increasing the costs of underwriting loans. The threat of litigation will breed greater caution among lenders and thus further restrict the availability of credit. The impact will be particularly hard on smaller community banks that lack the capacity to increase their compliance staff or to hire consultants. Already some are simply exiting the mortgage market.

The risks to lenders may be mitigated to some degree by meticulous compliance with the ability-to-repay procedures. But even the most vigilant lender will remain vulnerable because the regulatory parameters are somewhat fluid. (One irrational exception is the outright prohibition of basing a loan decision on the fact that an applicant's income derives from public assistance.[24])

Although there are specific rules for computing some asset and debt factors,[25] the bureau is allowing some flexibility in underwriting methods. This approach is both a benefit and a bane to lenders. On the one hand, lenders will enjoy some independence in designing ability-to-repay procedures. But it also means that there is no fixed compliance standard to follow, which invites arbitrary enforcement actions. As acknowledged by the bureau, "[The CFPB] does not believe that there is any litmus test that can be prescribed to determine whether a creditor, in considering those factors, arrived at a belief in the consumer's ability to repay which was both objectively reasonable and in subjective good faith."

In other words, the rule of law is what the bureau deems it to be at any particular point in time. This is a direct and undesirable consequence of Congress avoiding accountability by delegating its legislative authority to regulators. It is also a direct threat to fundamental principles of representative government.

22. John P. Scott, "Mortgage Lending Reform Under the Dodd-Frank Wall Street Reform and Consumer Protection Act," *Federation of Defense and Corporate Counsel Quarterly*, Vol. 63, No. 2 (Winter 2013).
23. Foote, Gerardi, and Willen, "Why Did So Many People Make So Many Ex Post Bad Decisions?"
24. "Consumer Financial Protection Bureau, Ability-to-Repay and Qualified Mortgage Standards Under the Truth in Lending Act," *Federal Register*.
25. At a minimum, creditors must consider eight underwriting factors: (1) current or reasonably expected income or assets; (2) current employment status; (3) monthly payment on the covered transaction; (4) monthly payment on any simultaneous loan; (5) monthly payment for mortgage-related obligations; (6) current debt obligations, alimony, and child support; (7) monthly debt-to-income ratio or residual income; and (8) credit history.

Even if a lender ultimately prevails in a legal challenge, it will not be spared the costs of litigation. According to data submitted to the CFPB, the average litigation cost to secure a motion to dismiss runs an estimated $26,000; summary judgment, $84,000; and trial, $155,000.[26]

Perversely, the CFPB is suggesting that lenders look to governmental entities, such as the FHA, for guidance on underwriting criteria. This is the agency that racked up a $16 billion deficit to its insurance fund last year, and which has requested a taxpayer bailout.

Qualified Mortgage "Safe Harbor"

The Dodd–Frank Act offers a "safe harbor" against potential ability-to-repay litigation in the form of a "qualified mortgage" (QM). Lenders who meet specific mortgage criteria, including loan limits, fee caps, and prescribed payment calculations, will be presumed to have satisfied the ability-to-repay criteria. The CFPB has also carved out a less absolute "rebuttable presumption" for higher-priced mortgages.[27] The relative safety of the QM means that lenders will be far less likely to offer loans that do not meet the QM criteria.[28]

Lenders lobbied hard for the safe harbor approach as protection from the litigation risk—which only exists because Congress created the new liability scheme to begin with. But there is also general recognition that establishment of the safe harbor will not eliminate litigation risk altogether. Consumers will still be able to file lawsuits; only the scope of the litigation will be delimited.

Perversely, the CFPB is suggesting that lenders look to governmental entities, such as the Federal Housing Administration—which racked up a $16 billion deficit and is requesting a taxpayer bailout—for guidance on underwriting criteria.

To be designated as a qualified mortgage, the interest rate cannot exceed 1.5 percentage points over the Average Prime Offer Rate;[29] points and fees most not exceed 3 percent of the loan; and the term of the mortgage cannot exceed 30 years. Of particular importance is the requirement that mortgage payments will not increase the borrower's debt-to-income ratio above 43 percent.

With very limited exception, balloon loans[30] are not eligible for QM status, nor are interest-only mortgages or negative amortization loans.[31] These limitations are based on the misconception that unconventional loans are "predatory" by nature, and played a major role in the housing collapse.[32]

Notwithstanding incessant banker-bashing, a variety of research documents that unconventional

26. "Consumer Financial Protection Bureau, Ability-to-Repay and Qualified Mortgage Standards Under the Truth in Lending Act," *Federal Register*.
27. As crafted by the CFPB, two different classes of loans are eligible to be "qualified mortgages." The distinction between the two is based on the annual percentage rate of the loan. The final rule provides a rebuttable presumption for "higher-priced" loans, that is, a residential mortgage loan with an APR of 6.5 percent above the Average Prime Offer Rate for first-lien loans; 8.5 percent for a second or subordinate-lien loan; total points and fees exceeding 5 percent of transaction amounts of $20,000 or more; or the lesser of $1,000 or 8 percent of a transaction smaller than $20,000. For loans that are not "higher-priced," the final rule provides a conclusive presumption that the creditor has satisfied the ability-to-repay requirements once the creditor proves that he has in fact made a qualified mortgage.
28. Dodd–Frank also calls for establishment of a Qualified Residential Mortgage (QRM). Home loans that satisfy the QRM criteria can be securitized 100 percent in the secondary market. For loans that are not eligible to be designated as a QRM, lenders are required to retain 5 percent of the credit risk.
29. The Average Prime Offer Rate is an annual percentage rate derived from average interest rates, points, and other loan-pricing terms currently offered to consumers by a representative sample of creditors for mortgage transactions that have low-risk pricing characteristics.
30. A balloon loan originated through 2016 that meets the other requirements may be designated as a "qualified mortgage" if it is originated and held in portfolio by a small creditor—defined as holding less than $2 billion in assets and originating 500 or fewer first mortgages per year.
31. A negative amortization loan features initial monthly payments that are less than the actual interest due, thereby increasing the total balance of the mortgage over time. Negative amortization loans allow borrowers to make lower monthly payments in the short term in exchange for higher payments in the long term.
32. As noted by John Allison, "Most people today view subprime lenders as taking advantage of poorly informed low-income borrowers. By the end of the process, this was certainly true in some cases. But it is important to remember that subprime lending was primarily driven by government policy based on a goal of wealth redistribution." Allison, *The Financial Crisis and the Free Market Cure*, p. 57.

lending did not cause the crisis. According to economist Yuliya Demyanyk, formerly of the Federal Reserve Bank of St. Louis,

> It was a market-wide phenomenon. For example, borrowers with mortgages that carried a fixed-interest rate—the rate that will not reset through the entire term of a loan—had very similar problems to borrowers with hybrid mortgages. Borrowers who obtained a subprime mortgage when they bought a home had the same problems in 2006 and 2007 as those who refinanced their existing mortgages to extract cash. Borrowers who provided full documentation and no documentation followed the same pattern.[33]

In reality, each type of mortgage is beneficial for specific types of borrowers. Balloon mortgages, which feature lower interest rates and monthly payments, are appropriate for homebuyers who plan to sell their house before the balance of the loan (the balloon payment) is due. They also may prove to be profitable if home values are rising consistently; the additional equity will help to secure refinancing to make the balloon payment. On the other hand, interest-only mortgages are ideal for borrowers with irregular incomes or those who anticipate an increase in earnings in the future.

Barring such loans under the QM regime means fewer options for would-be homebuyers, and a new barrier to the wealth creation associated with property investment. This is not consumer protection, but consumer control.

The same authoritarianism pervades the QM's debt-to-income requirement. Although a DTI ratio of 43 percent falls within the range of industry standards, there is infinite variety among borrowers' circumstances that bankers would otherwise take into account. The DTI constraint will increase the number of applicants who will be rejected for loans they could afford while others obtain ones they cannot manage.

The Federal Reserve Board, during previous deliberations on the issue,[34] declined to propose a specific debt-to-income ratio for qualified mortgages out of concern that doing so could limit credit availability. The board also concluded that setting a quantitative standard would oblige it to micromanage underwriting, such as defining income and debt obligations and compensating factors.

CFPB officials acknowledge that the 43-percent threshold will be problematic for some would-be borrowers. For example, a total of 23 percent of the loans acquired by Fannie Mae and Freddie Mac between 1997 and 2009 had debt-to-income ratios of 44 percent or greater, according to data from the Federal Housing Finance Agency. Over the same period, 19 percent of the loans had DTIs of 46 percent or greater.

Barring unconventional mortgages means fewer options for would-be homebuyers, and a new barrier to the wealth creation associated with property investment. This is not consumer protection, but consumer control.

The bureau's DTI threshold is based on the "general boundary" of affordability utilized by the FHA—hardly a paragon of prudent lending, as previously noted. In contrast, Fannie Mae's and Freddie Mac's guidelines link the required debt-to-income ratio to the credit score of the borrower. Those with credit scores below 700 generally require a debt-to-income ratio of 36 percent, while borrowers with a credit score above 700 may be eligible with a DTI of 45 percent.[35]

There is a gradual increase in mortgage delinquency rates as debt increases in relation to income. But there is virtually no difference between a DTI of 42 or 45. Numerous other factors have a stronger correlation to loan repayment. For example, the loan-to-value ratio and credit score are much more predictive of loan performance than DTI, according to the Mortgage Bankers Association.[36]

33. Yuliya Demyanyk, "Did Credit Scores Predict the Subprime Crisis?" *The Regional Economist*, Federal Reserve Bank of St. Louis, October 2008, http://www.stlouisfed.org/publications/re/articles/?id=963 (accessed November 21, 2013).
34. "Consumer Financial Protection Bureau: Ability-to-Repay and Qualified Mortgage Standards Under the Truth in Lending Act," *Federal Register*.
35. Fannie Mae, "Eligibility Matrix," 2013, https://www.fanniemae.com/content/eligibility_information/eligibility-matrix.pdf (accessed November 21, 2013).
36. Comments submitted to the Consumer Financial Protection Bureau by the Mortgage Bankers Association on July 9, 2012.

The CFPB acknowledges that there is no "magic number" which separates affordable from unaffordable mortgages. Whether the 43 percent DTI ratio is better than, say, 40 or 46, is rather beside the point, however. Any fixed standard will inhibit lenders from making judgments based on an applicant's character, the state of the market, their experience, or a host of other factors. But those are better predictors of creditworthiness than the directives of bureaucrats passing judgment from thousands of miles away.

In recent congressional testimony, bank director James Gardill warned that a static set of loan criteria will mean a lot fewer mortgages. There are "many American families across the country that are creditworthy but do not fit inside the QM 'box,'" he said.[37] Likewise, the California & Nevada Credit Union Leagues note that even more affluent borrowers may find their access to credit diminished under the QM rules. "A borrower earning $10,000 or $15,000 a month, with no non-housing debts, might have trouble getting a mortgage if his house payment plus taxes and insurance totaled 45 percent of his gross income."[38]

Particularly hard hit will be young adults. As first-time homebuyers, they may have limited income and college debt, pushing their DTI above "qualified" status. But these are the very buyers who prompt churn in the market, that is, their entry allows current homeowners to parlay their equity into a second better home, fueling upward mobility along the property chain.

New retirees also are vulnerable because they rely on assets rather than income to cover housing payments. As such, the CFPB rule could place "significant limitations on the amount of new mortgage credit available to these customer segments and further restrict their home-buying choices."[39]

Advocates argue that the standardization of mortgages would have gone a long way toward preventing the massive defaults of 2006 to 2009. But it was not lack of regulation that prompted the loosening of standards. The more salient factors were artificially low interest rates and the shift of mortgage risk from private lenders to government, both of which spurred exuberant investment in housing and lowered underwriting standards.[40]

Disparate Impact

With one hand, the bureau presumes to mitigate the risk of litigation with the qualified mortgage, but then overwhelms the effort by setting the trap of "disparate impact." That is, lenders could face stiff penalties if their pool of borrowers is, by government standards, insufficiently "diverse."

Disparate impact is the race-based measurement of outcomes or results, which, absent discriminatory intent, condemns the actor to penalty. In this instance, lenders will be judged on whether their pool of borrowers is sufficiently "diverse" regardless of the neutrality of their underwriting policies. But the qualified mortgage rule, with its inflexible debt-to-income requirements and loan parameters, increases the likelihood that less affluent borrowers—and consequently more minority borrowers—will not be eligible for a qualified mortgage. It is a regulatory Catch-22.[41]

37. "Testimony of James Gardill on Behalf of the American Bankers Association Before the Financial Institutions Subcommittee of the [House] Financial Services Committee," American Bankers Association, June 18, 2013, http://www.aba.com/Issues/Testimonies/Documents/JCG%20Testimony%20on%20behalf%20of%20ABA%20before%20Financial%20Institutions%20Subcommittee.pdf (accessed November 21, 2013).

38. E. Scott Reckard, "Local Lenders Say U.S. 'Qualified Mortgage' Rules Go Too Far," *Los Angeles Times*, May 27, 2013, http://articles.latimes.com/2013/may/27/business/la-fi-qualified-mortgage-20130528 (accessed November 21, 2013).

39. Val Srinivas and Ryan Zagone, "First Look: Implications of the Ability-to-Repay Rule and the Qualified Mortgage Definition," Deloitte Center for Financial Services, 2013, https://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/FSI/US_FSI_FirstLook_012413.pdf (accessed December 10, 2013).

40. For a broader discussion of the causes see Foote, Gerardi, and Willen, "Why Did So Many People Make So Many Ex Post Bad Decisions?"; Allison, *The Financial Crisis and the Free Market Cure*; and Wallison, *Bad History, Worse Policy*.

41. In response to lenders' concerns, the CFPB has advised lenders to "continue to evaluate fair lending risk as they would for other types of product selections, including by carefully monitoring their policies and practices and implementing effective compliance management systems." News release, "Interagency Statement on Fair Lending Compliance and the Ability-to-Repay and Qualified Mortgage Standards Rule," Consumer Financial Protection Bureau, Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and National Credit Union Administration, October 22, 2013, http://files.consumerfinance.gov/f/201310_cfpb_guidance_qualified-mortgage-fair-lending-risks.pdf (accessed November 25, 2013).

Officials have repeatedly warned lenders that the CFPB is wholly committed to employing disparate impact analysis in its oversight of the financial sector.[42] Likewise, the Department of Housing and Urban Development (HUD) has announced plans to track racial diversity in neighborhoods for a new "discrimination database." It remains unclear just how lenders are supposed to abide by the stricter mortgage requirements and avoid disparate impacts.

The CFPB presumes to mitigate the risk of litigation with the qualified mortgage, but overwhelms the effort by setting the trap of "disparate impact." Lenders will face stiff penalties if their pool of borrowers is, by government standards, insufficiently "diverse."

Ironically, similar requirements were a factor in the housing crash. The Housing and Community Development Act of 1992 required that 30 percent of all loans acquired by Fannie Mae and Freddie Mac be made to low-income and moderate-income borrowers.[43] By 2007, the quota had reached a whopping 55 percent, which required a considerable loosening of underwriting standards to achieve.

Servicing Rules

The term "servicing" refers to the administration of a mortgage, including billing, accounting, and customer communications. The new mortgage rules amend two existing regulatory regimes: (1) the Real Estate Settlement Procedures Act (Regulation X), and (2) the Truth in Lending Act (Regulation Z). The changes are intended to prevent some of the practices engaged in by mortgage servicers during the foreclosure frenzy, such as filing foreclosures without proper documentation, failure to review foreclosure documents before signing, and filing foreclosures despite offers to modify loans. Many of the new provisions reflect the terms of the $25 billion National Mortgage Settlement between state attorneys general, the federal government, and five major lenders accused of servicing misconduct.

Along with new obligations for lenders, the regulations grant borrowers a host of new "rights"—some of which are mandated by Dodd–Frank and many that are not. The new provisions address nine general topics: (1) requirements for billing statements; (2) interest rate adjustments; (3) crediting of payments; (4) payoff statements; (5) force-placed insurance; (6) complaint management; (7) intervention with delinquent borrowers; (8) loss-mitigation procedures; and (9) policies and procedures.

Such attention to customer relations goes far beyond Dodd–Frank's stated goal of "economic stabilization," and is indicative of the statute's expansive regulatory scope, in general, and the CFPB, in particular. For example, the rules dictate the number of days in which a creditor must respond to a customer inquiry (five) or supply mortgage payoff information (seven) and various other communications. These and other paperwork requirements create new potential violations over which borrowers may litigate.[44]

New time lines in foreclosure proceedings also are a concern. The mortgage servicer is now prohibited from filing any foreclosure-related document until the borrower is more than 120 days delinquent. Conventional accounting rules require lenders to take action when a loan is 90 days late. The new grace period also conflicts with default notification requirements in the states.

Prolonging a foreclosure notice means that the borrower's delinquency will be more severe and, therefore, more likely to end in foreclosure. The 120-day rule also bars lenders from access to collateral that would otherwise provide revenue for new loans, thus affecting the availability of credit. This could be particularly problematic for community banks that

42. The U.S. Supreme Court had granted a petition for certiorari in a case that would have decided whether disparate impact liability can be imposed under the Fair Housing Act. Stephen A. Fogdall, "The U.S. Supreme Court Grants Cert to Decide Whether the Fair Housing Act Allows for Disparate Impact Claims in Township of Mount Holly v. Mt. Holly Gardens Citizens in Action, Inc.," Mondaq, July 9, 2013, http://www.mondaq.com/unitedstates/x/249480/trials+appeals+compensation/The+US+Supreme+Court+Grants+Cert+To+Decide+Whether+The+Fair+Housing+Act+Allows+For+Disparate+Impact+Claims+In+Township+Of+Mount+Holly+v+Mt+Holly+-Gardens+Citizens+In+Action+Inc (accessed November 21, 2013). However, the case has since been settled.

43. Defined as borrowers with incomes at or below the median in the communities where they lived.

44. Scott, "Mortgage Lending Reform Under the Dodd–Frank Wall Street Reform and Consumer Protection Act."

keep mortgages in-house rather than selling them in the secondary market.

The regulations also require mortgage servicers to review or qualify a borrower for all possible "mitigation" options before foreclosure. The enumerated steps will impose a heavy burden on both the borrower and the lender regardless of whether the parties wish to pursue a particular option. Why force a borrower and lender to evaluate, say, a short sale when he or she has specifically requested another mitigation option?

If anything, the added cost of reviewing all mitigation alternatives will likely result in fewer options being made available. A similar level of attention to consequences runs through most of the new and extensive servicing requirements.

Delay

The CFPB has acknowledged the fragility of the housing market and the potential disruption that is likely to result from the new regulations. Consequently, officials are offering a reprieve, of sorts, albeit one of dubious merit.[45]

To avert a further tightening of credit when the mortgage regulations take effect in January, the CFPB is providing a "temporary alternative" definition of qualified mortgage. This provision waives the requirement that a borrower must have a debt-to-income ratio at, or below, 43 percent for a loan to be designated as a qualified mortgage. Instead, the loan must satisfy general product feature requirements and fee limits, and satisfy the underwriting requirements of either Fannie Mae or Freddie Mac[46] (while under government conservatorship); the Department of Housing and Urban Development; the VA; the Agriculture Department (USDA); or the Rural Housing Service (RHS).[47]

Resorting to provisional rules reflects the difficulty of crafting federal regulations that complement rather than disrupt the housing market.

The inclusion of the two government-sponsored enterprises (GSEs) on this list is an odd one. Whatever their underwriting standards now, Fannie and Freddie are hardly paragons of responsible lending. These two quasi-public enterprises, now under government conservatorship, failed to maintain the capital reserves necessary to cover the mortgage guarantees they sold for up to half the nation's residential mortgage market. Their irresponsibility led to a taxpayer bailout of some $150 billion.

Fannie Mae and Freddie Mac, quasi-public enterprises now under government conservatorship, failed to maintain the capital reserves necessary to cover the mortgage guarantees they sold for up to half the nation's residential mortgage market—leading to a taxpayer bailout of some $150 billion.

Officials contend that Fannie Mae and Freddie Mac are establishing better controls on the mortgages they buy. But the stunning losses were symptomatic of the housing bubble that both enterprises helped to create. As explained by former Heritage Foundation analyst Ronald Utt, Fannie and Freddie operated with government privileges that allowed them to borrow at interest rates well below those paid by private companies. That access to cheap capital—and the implicit government guarantee of their debt—allowed the enterprises to buy up mortgages at an unprecedented rate, thereby creating massive liquidity in the housing finance market. That liquidity, in turn, prompted a loosening of lending standards and, ultimately, the housing crash.

45. Some analysts suggest that there is another factor in play: Waiving the debt-to-income ratio allows Fannie Mae, Freddie Mac, and other government agencies to benefit from QM treatment without any change to their underwriting standards. PricewaterhouseCoopers, "CFPB Ability-to-Repay Standard: An Analysis of the Consumer Financial Protection Bureau's Ability-to-Repay and Qualified Mortgage Rule," 2013, http://www.pwcregulatory.com (accessed November 21, 2013).

46. Fannie and Freddie do not offer individual mortgages; they package loans made by banks and other lenders into securities for sale, providing guarantees to investors should the loans default.

47. The FHA, VA, USDA, and RHS have authority under the statute to define qualified mortgage standards for their own loans, so coverage under § 1026.43(e)(4) will sunset once each agency promulgates its own qualified mortgage standards and such rules take effect. See TILA section 129C(b)(3)(ii). Coverage of GSE-eligible loans will sunset when conservatorship ends.

Unlike business, government operates under the conceit of being all-knowing and impartial. In reality, it lacks reliable information and is driven by political considerations. The competitive market, in contrast, is a dynamic organism that adjusts to new information and consumer preferences from moment to moment, and place to place. It is not perfect, of course, which is why government does have a legitimate role in protecting consumers against fraud and such. But government promotes standardization and waste while the market promotes innovation and efficiency. The government seeks to transfer wealth while the market creates wealth. Consequently, Dodd–Frank's new mortgage regime is a poor substitute for a competitive marketplace.

The propagandized account of the financial crisis produced a regulatory scheme that fails to address the primary causes, and that will unnecessarily restrict mortgage financing and undermine recovery of the housing sector.

Conclusion

Washington's response to the financial crisis was predicated on the notion that the housing bubble and subsequent crash were the fault of unscrupulous mortgage lenders and investors who took advantage of naive, uninformed consumers. Thus, the remedy formulated by Congress focuses on government control of virtually every aspect of housing finance. There is no attempt to address the government policies that contributed mightily to the crisis.

The 3,500 pages of new mortgage regulation will not guarantee that a housing bubble and collapse will not happen again. Nor can such inflexible standards possibly keep pace with the constant changes in market conditions. But it will constrain the availability of credit and increase the costs. Such a regime eviscerates the fundamental principles of a mortgage "market," thereby punishing consumers more than protecting them.

The propagandized account of the crisis produced a regulatory scheme that fails to address the primary causes, and that will unnecessarily restrict mortgage financing and undermine recovery of the housing sector. The most appropriate remedy would be to eliminate the regulations.[48] In the interim, the following steps would lessen the damage. Congress should:

1. **Delay implementation of the rules.** The unparalleled scope of Dodd–Frank rulemaking—some 400 new regulations, in all—has imposed enormous new regulatory burdens across the finance sector. The problem is exacerbated by the government's protracted rulemaking and failure to meet statutory deadlines. The CFPB, for example, was issuing mortgage financing rules as late as last month that are slated to take effect in just four weeks. But that does not leave the time necessary to prepare for compliance. Consequently, the effective date of all mortgage finance regulations should be delayed by at least one year to provide lenders adequate time to adapt to the radical changes in mortgage rules.

2. **Prohibit enforcement actions for disparate impact.** Bureau officials have announced their intent to aggressively punish lenders by applying the notion of disparate impact to mortgage loans, that is, the race-based measurement of outcomes which, absent discriminatory intent, condemns the firm to penalty. The bureau should be prohibited from applying such a dubious analysis in any enforcement action.

3. **Impose accountability on the CFPB.** Bureau funding is set by law at a fixed percentage of the Federal Reserve's operating budget. This budget independence limits congressional oversight of the agency, and its status within the Fed also precludes presidential oversight. This funding mechanism should be abolished, and the CFPB should instead be subject to the congressional appropriations process. There is no justification for allowing the bureau to escape congressional oversight.

48. The House Financial Services Committee on July 24 approved H.R. 2767, the Protecting American Taxpayers and Homeowners Act, which would, among other things, ease fee limits on qualified mortgages and delay implementation of other mortgage regulations until 2015.

4. **Craft meaningful reform.** Dodd–Frank failed to address the primary drivers of the housing crash. Congress should focus on eliminating Fannie Mae and Freddie Mac, and addressing the monetary policies that fed the bubble.

In many ways, Dodd–Frank and the mortgage finance regulations it spawned are similar to Obamacare. Both are attempts by Washington to control a complex and dynamic sector of the economy. If left unchanged, both will produce more harm than benefit. Congress would do well to eliminate the misguided mortgage rules rather than put Americans through a mortgage debacle in addition to the health care debacle.

*—**Diane Katz** is a Research Fellow for Regulatory Policy in the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation.*

Appendix:

Mortgage Regulations Adopted by the CFPB

Escrow Requirements *Federal Register* / Vol. 78, No. 14 / January 22, 2013	The rule lengthens the time for which a mandatory escrow account that was established for a higher-priced mortgage loan must be maintained. The rule also exempts certain transactions from the statute's escrow requirement.
Ability-to-Repay and Qualified Mortgage Standards *Federal Register* / Vol. 78, No. 20 / January 30, 2013	The rule implements sections 1411 and 1412 of the Dodd–Frank Act, which require lenders to make a reasonable, good-faith determination of a consumer's ability to repay any consumer credit transaction secured by a dwelling. It also establishes certain protections from liability under this requirement for "qualified mortgages," limits prepayment penalties, and requires creditors to retain evidence of compliance with the rule for three years after a loan is consummated.
High-Cost Mortgage and Homeownership Counseling Amendments *Federal Register* / Vol. 78, No. 21 / January 31, 2013	The rule expands the types of mortgage loans that are subject to the Home Ownership and Equity Protections Act of 1994, revising and expanding the tests for coverage and imposing additional restrictions, including a pre-loan counseling requirement. The final rule also requires consumers to receive information about homeownership counseling providers.
Disclosure and Delivery Requirements for Copies of Appraisals and Other Written Valuations *Federal Register* / Vol. 78, No. 21 / January 31, 2013	The rule requires creditors to provide to applicants free copies of all appraisals and other written valuations developed in connection with an application for a loan, and requires creditors to notify applicants in writing that copies of appraisals will be provided to them promptly.
Appraisals for Higher-Priced Mortgage Loans *Federal Register* / Vol. 78, No. 30 / February 13, 2013	For mortgages with an annual percentage rate that exceeds the Average Prime Offer Rate by a specified percentage, the final rule requires creditors to obtain an appraisal or appraisals meeting certain specified standards, provide applicants with a notification regarding the use of the appraisals, and give applicants a copy of the written appraisals used.
Mortgage Servicing Rules Under the Real Estate Settlement Procedures Act *Federal Register* / Vol. 78, No. 31 / February 14, 2013	The rule addresses servicers' obligations to correct errors asserted by mortgage loan borrowers; to provide certain information requested by such borrowers; and to provide protections to such borrowers in connection with force-placed insurance. Additionally, the rule addresses servicers' obligations to establish reasonable policies and procedures to achieve certain delineated objectives; to provide information about mortgage loss-mitigation options to delinquent borrowers; to establish policies and procedures for providing delinquent borrowers with continuity of contact with servicer personnel capable of performing certain functions; and to evaluate borrowers' applications for available loss-mitigation options. The rule revises provisions relating to mortgage servicers' obligation to provide disclosures to borrowers in connection with transfers of mortgage servicing, and mortgage servicers' obligation to manage escrow accounts, including restrictions on purchasing force-placed insurance for certain borrowers with escrow accounts and requirements to return amounts in an escrow account to a borrower upon payment in full of a mortgage loan.

(continued on next page)

B 2866 heritage.org

Appendix (continued):

Mortgage Regulations Adopted by the CFPB

Mortgage Servicing Rules Under the Truth in Lending Act *Federal Register* / Vol. 78, No. 31 / February 14, 2013	The rule addresses initial rate adjustment notices for adjustable-rate mortgages, periodic statements for residential mortgage loans, prompt crediting of mortgage payments, and responses to requests for payoff amounts. It also amends current rules governing the scope, timing, content, and format of disclosures to consumers regarding the interest rate adjustments of their variable-rate transactions.
Loan Originator Compensation Requirements *Federal Register* / Vol. 78, No. 32 / February 15, 2013	The rule implements requirements and restrictions on loan originator compensation, qualifications and registration or licensing, compliance procedures for depository institutions, mandatory arbitration, and the financing of single premium credit insurance. The rule also establishes tests for when loan originators can be compensated through certain profit-based compensation arrangements.
Disclosure of Records and Information *Federal Register* / Vol. 78, No. 32 / February 15, 2013	This rule establishes procedures for the public to obtain information from the CFPB under the Freedom of Information Act, the Privacy Act of 1974, and in legal proceedings. This final rule also establishes the CFPB's rule regarding the confidential treatment of information obtained from persons in connection with the exercise of its authorities under federal consumer financial law.
Amendments to the 2013 Mortgage Rules Under the Real Estate Settlement Procedures Act and the Truth in Lending Act *Federal Register* / Vol. 78, No. 205 / October 23, 2013	This rule amends final rules that require consumers to receive counseling before obtaining high-cost mortgages; servicers to provide periodic account statements and rate-adjustment notices to borrowers and engage in early intervention when borrowers become delinquent; the disclosures that must be provided before counseling for high-cost mortgages can occur; and servicing requirements when a consumer is in bankruptcy or sends a cease communication request.
Integrated Mortgage Disclosures under the Real Estate Settlement Procedures Act (Regulation X) and the Truth In Lending Act (Regulation Z) Submitted to the *Federal Register* on November 20, 2013.	As required by Dodd–Frank, the rule amends Regulation X (Real Estate Settlement Procedures Act) and Regulation Z (Truth in Lending) to establish new disclosure requirements and forms for most mortgages. According to the CFPB, the rule is intended to "simplify" the mortgage process. The rule runs 1,888 pages.

B 2866 heritage.org