The Heritage Foundation
LEADERSHIP FOR AMERICA

ISSUE BRIEF

No. 3826 | JANUARY 14, 2013

Mortgage Regulation: Is CFPB Qualified?

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More stringent regulation of mortgage lending constitutes a sizable chunk of the vast Dodd–Frank statute. As required, the Consumer Financial Protection Bureau (CFPB) on Thursday released more than 800 pages of rules that will largely determine the availability and cost of mortgages. Neither consumers nor creditors emerge as winners.

The mortgage rules were called for by Congress in response to the flood of foreclosures associated with the financial crisis. Too many homebuyers obtained loans that they simply could not afford. The Dodd–Frank Act thus requires lenders to verify and document that mortgage applicants have the "ability to repay" a loan under the terms offered. Lawmakers also directed regulators to establish mortgage criteria that, if met, would be presumed to satisfy the ability-to-repay requirements.

Irresponsible lending did indeed play an important role in the virtual collapse of the housing market. But a complex array of other factors—including deeply flawed government policies—also contributed. The regulations required by Congress and crafted by the CFPB fail to address more fundamental aspects of the problem and instead introduce potential constraints on a recovery of the housing sector.

The CFPB acknowledges that the regulatory crackdown will reduce the availability of mortgage credit and increase borrowing costs. Consequently, it also issued a set of "temporary"[1] and "more flexible" regulations that include easing the debt-to-income ratio required for designating a loan as a "qualified mortgage."[2] Resorting to provisional rules reflects the difficulty of crafting federal regulations that complement rather than disrupt the dynamic housing market. Nor can such rules substitute for a well-functioning marketplace.

Determining Ability to Repay. The CFPB's rules require lenders to consider eight factors when processing a loan application:

1. Current or reasonably expected income or assets;
2. Current employment status;
3. The monthly payment on the covered transaction;
4. The monthly payment on any simultaneous loan;
5. The monthly payment for mortgage-related obligations;
6. Current debt obligations, alimony, and child support;
7. The monthly debt-to-income ratio; and
8. Credit history.

The bureau also has issued "guidance" on how each factor is to be calculated.

To be sure, these factors are relevant to mortgage lending, and they were too often ignored—by creditors and consumers alike—in the heat of the housing bubble. But most lenders have already instituted tighter credit standards in the wake of the housing collapse. So tight, in fact, that even the most qualified borrowers are finding it tough to

This paper, in its entirety, can be found at
http://report.heritage.org/ib3826

Produced by the Thomas A. Roe Institute for Economic Policy Studies

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qualify for a loan. Even CFPB director Richard Cordray acknowledged that the availability of credit is "achingly tight."[3] Although a number of consumer activist groups regard the regulations as too soft on financial institutions, the cost of complying with 800 pages of rules will not likely ease the difficulty of obtaining a loan.

Market Distortions. The CFPB has also delineated the criteria to be used in determining whether a loan can be designated as a "qualified mortgage." These loan provisions and underwriting requirements will entitle lenders to a "conclusive presumption" of compliance with the ability-to-repay requirements.

Dodd–Frank granted borrowers a startling new cause of action in the event of a mortgage default: the right to sue lenders for improperly assessing their ability to repay the loan. Therefore, lenders who write loans that do not meet the criteria of a "qualified mortgage" will face a much greater risk of litigation. That risk will deter creditors from offering alternatives to the government-preferred mortgages, thereby tightening loan availability.

Of particular importance is the requirement that the mortgage would not push a borrower's debt-to-income ratio above 43 percent.[4] Additionally, points and fees are capped at 3 percent.[5]

Such inflexible standards cannot possibly keep pace with the constant changes in market conditions. And by interfering with the fluidity of housing supply and demand, the regulations will invite some of the very market distortions that fueled the financial crisis. Moreover, there is infinite variety among borrowers' circumstances, and regulatory constraints will increase the likelihood that applicants will be rejected for loans they could afford while others obtain ones they cannot handle.

In addition, the CFPB is seeking comment on whether to adjust the qualified mortgage rules for community-based lenders, housing-stabilization programs, and certain refinancing programs of Fannie Mae and Freddie Mac.[6]

This is perverse. Fannie Mae and Freddie Mac should not be awarded a competitive advantage over their private-sector counterparts. Their past actions—including an epic failure to properly evaluate risk—contributed to the housing market collapse. Any presumption that they have permanently reformed could backfire at some point in the future.

Regulatory Redundancy. Spanning more than 2,500 pages, the overall Dodd–Frank statute is a paean to bureaucracy. Thus, it should come as little surprise that the CFPB rules on qualified mortgages are probably redundant. Six other federal agencies are also jointly developing qualified mortgage standards intended to reduce mortgage risk and stabilize the housing market.[7]

Under Dodd–Frank, Congress directed the agencies to develop separate regulations that would help to reduce the risk of toxic loans. The proposed rule would require lenders who bundle mortgages for sale to retain 5 percent of the value of any mortgage that does not meet the standards of a "qualified residential mortgage." The idea is that creditors who sell mortgage securities will not want to hold a portion of those lower quality loans on their books. Presumably, then, they will be encouraged to limit the number of lower quality loans that they write

1. According to the CFPB, the temporary provisions will phase out over time as various federal agencies issue their own qualified mortgage rules, the end of conservatorship for Fannie Mae and Freddie Mac, or after seven years.
2. A "qualified mortgage" is one that entitles lenders to a "conclusive presumption" of compliance with the ability-to-repay requirements. To be designated as a "qualified mortgage" under the temporary rules, the loan would still have to satisfy the underwriting requirements necessary for it to be purchased, guaranteed, or insured by either (1) government-sponsored enterprises (Fannie Mae and Freddie Mac) while they operate under federal conservatorship or receivership; or (2) the U.S. Department of Housing and Urban Development, Department of Veterans Affairs, Department of Agriculture, or Rural Housing Service.
3. Richard Cordray, "Assuring Consumers Have Access to Mortgages They Can Trust," Consumer Financial Protection Bureau blog, January 10, 2013, http://www.consumerfinance.gov/blog/assuring-consumers-have-access-to-mortgages-they-can-trust// (accessed January 14, 2013).
4. The appendix to the rule details the calculation of debt-to-income for these purposes, drawing upon Federal Housing Administration guidelines for such calculations.
5. The final rules also bar loans with negative amortization, interest-only payments, balloon payments, or terms exceeding 30 years from designation as qualified mortgages.
6. In the case of the latter two housing finance giants, there would be a presumption that any loans they purchase and package into securities would meet the standard.
7. These agencies are the Credit Risk Retention, Office of the Comptroller of the Currency, Department of the Treasury; the Board of Governors of the Federal Reserve System; the Federal Deposit Insurance Corporation; the U.S. Securities and Exchange Commission; the Federal Housing Finance Agency; and the Department of Housing and Urban Development.

and instead limit their offerings to the more tightly regulated loans.

Constraining Housing Recovery. The CFPB and its allies are characterizing the new mortgage rules as much-needed protection for vulnerable consumers imperiled by unscrupulous lenders. In reality, many borrowers were irresponsible in assuming more debt than they could possibly repay. Rather than protect unwitting homebuyers, the new rules will foreclose loan options and raise mortgage costs.

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