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Statement No. 344

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Statement of the Shadow Financial Regulatory Committee on

The New Qualified Residential Mortgage Rule Proposal

September 23, 2013

The Shadow Financial Regulatory Committee has been critical of the Dodd-Frank Act in the past, but in at least one area the drafters of the Act got it right: it attempted to address the problem of subprime and other low-quality mortgages that failed in large numbers when the housing bubble burst in 2007 and 2008 and led to a serious financial crisis. The Act did this by establishing two standards—a minimum standard and a high standard—for mortgages that would be allowed into the securitization system.

The minimum standard, known as the Qualified Mortgage (QM), was to be developed by the Consumer Financial Protection Bureau and was published in January of this year. The QM also required that the originator make a good faith determination that the borrower has the ability to repay the loan, and that after the loan has been closed the borrower will not have a debt-to-income ratio that exceeds 43%. The penalties for violating the minimum standard were severe, and could include a borrower's defense to foreclosure if the lender had failed to document that the borrower could afford to repay the mortgage.

In order to be sure that mortgage securitizers bore the risks associated with QM loans, the rule required that they retain at least 5% of the risk by holding a slice of the mortgage pool. A safe harbor or a rebuttable presumption was available to protect lenders in cases that involved variances from certain of the QM rules. For example, if the 43% DTI limit was exceeded, the lender could still get safe harbor protection if the loan was acceptable to the automated underwriting system of a government agency such as one of the GSEs. The rule also excluded amortization (interest only); and (ii) mortgages that lack adequate documentation, exceed 30 years in maturity, involved points and fees that exceed 3 percent, or were priced at 150 basis points more than the Average Prime Offer Rate (APOR).

High quality loans are called the Qualified Residential Mortgage (QRM) in the Act. All the requirements of the QM had to be followed, but the Act dispensed with the 5% risk retention because the mortgage was supposed to be of such quality that its likelihood of default was low. The Act did not specify the terms of the QRM, but left it to the relevant regulatory agencies to develop and publish the terms by regulation. The agencies' first effort to set out the proposed terms for the QRM included a 20% downpayment provoked widespread opposition in the mortgage industry. Opponents contended that a 20% downpayment would exclude some low income, minority and first-time homebuyers from the opportunity to buy homes. This led the agencies went back to the drawing board, and in late August this year they published a new proposal for a QRM.

In their August 28 release, the agencies completely abandoned the Act's requirement for a separate high-quality QRM. Instead, they proposed a QRM that was essentially the equivalent of the QM. This not only violated the congressional intent and nullified the retainage, but it pushed the US mortgage system back toward the very policies that fed the housing bubble, the mortgage meltdown and the financial crisis. It responds to those want the mortgage finance system to make mortgage credit widely available, but it ignores the need for a stable system that will avoid a future crisis.

Neither the QM nor the QRM requires that a borrower have a solid credit history or make a downpayment. While lenders will have to determine that borrowers have the ability to repay the loan at the time of the closing, that makes no allowance for the subsequent loss of employment, divorce, illness or the other vicissitudes of life that can make it difficult for people to meet their financial obligations. For example, in their release, the agencies admitted that, in the case of mortgages that met the QM standard between 2005 and 2008, 23 percent experienced a period of serious delinquency or default by 2012. In other words, if the new QRM standard is adopted for all mortgages in the future, it is likely that a 23 percent serious mortgage delinquency or default rate will be common in the US housing finance system if the economy performs as it did in 2005 to 2008.

That the roots of this proposal are more political than economic is clear when the agencies noted that they are "concerned about the prospect of imposing further constraints on mortgage credit availability at this time, especially as such constraints might disproportionately affect groups that have historically been disadvantaged in the mortgage market, such as lower-income, minority, or first-time home buyers."

Apparently, the agencies that issued this release are less concerned than Congress about the quality of the mortgages in the financial system, and more concerned about making sure that mortgage credit is widely distributed than that the mortgage system is safe and sound. Even Barney Frank, one of the key drafters of the Dodd-Frank Act and a long-time supporter of the affordable housing goals, eventually recognized that this was an enormous error, noting in

August 2010: "it was a great mistake to push lower-income people into housing they couldn't afford and couldn't really handle once they had it."[1]

The Committee is disappointed that such a proposal could emerge from agencies that are supposed to be concerned about the safety and soundness of the financial system, and notes that the serious delinquencies and defaults in the mortgages acquired by Fannie Mae and Freddie Mac never approached 23 percent, yet were sufficient to cause their insolvency

The Shadow Financial Regulatory Committee believes that the events of 2007 and 2008 adequately demonstrated the unfortunate consequences of encouraging deterioration in mortgage underwriting standards. The agencies should withdraw this proposal and re-propose a QRM that meets the statutory requirement for high quality mortgages that have only a minimal likelihood of default and protects the stability of our financial system.

[1] Larry Kudlow, "Barney Frank Comes Home to the Facts," GOPUSA, August 23, 2010, available at http://www.gopusa.com/commentary/2010/08/23/kudlow_barney_frank_comes_home_to_the_facts/ (accessed September 23, 2013).