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Statement of the Shadow Financial Regulatory Committee on
**Caveat Creditor: Qualified Mortgage Ruled Fails to Protect
Borrowers or the Economy**

February 11, 2013

The Qualified Mortgage (QM) rule recently finalized by the Consumer Financial Protection Bureau (CFPB) is a highly complex regulation with a contradiction at its core.

The rule attempts to prevent losses to mortgage borrowers by penalizing the lender who makes a loan that a borrower could not repay. To that end, the rule places on lenders the burden of determining whether a borrower has the resources to repay the obligation he has assumed. If the borrower defaults, and the lender attempts to foreclose, the borrower can pursue various penalties against the lender as a defense to foreclosure.

If the loan is a QM, the lender in turn is granted certain defenses against the borrower's claims in a foreclosure action. To have access to these defenses, the lender must show that it made a reasonable and good faith attempt to document the borrower's resources, including such things as the borrower's income, assets, employment and credit history, and the mortgage must comply with other QM terms. For example, it must amortize principal in even monthly payments over no longer than 30 years, the interest rate may be no higher than 1.5% over the local average prime offer rate (APOR) for mortgages, and the points and fees on the loan may not exceed 3%. If these standards are met, the lender is eligible for a "safe harbor" against later claims by a delinquent borrower that the lender did not adequately investigate the borrower's ability to repay.

If the rate on the loan exceeds 1.5% over the APOR, but does not exceed 3%, the lender is still eligible for a rebuttable presumption that it complied with all the other terms of the QM rule outlined above. Despite the existence of a safe harbor or a rebuttable presumption, the commentary accompanying the rule makes clear that the borrower can still challenge the loan in the context of the foreclosure action, but he will have a more difficult task if the lender has a safe harbor or a rebuttable presumption.

However, when one turns to underwriting standards required by the rule it is clear that the borrower is not protected against default. This is because the lender need only comply with minimal underwriting standards in order to qualify its mortgage as a QM. The lender must meet only one of two underwriting tests: either the borrower's debt-service-to-income ratio (DTI) will not exceed 43% after the loan is made, or the loan is eligible for purchase or insurance by the automated underwriting systems (AUS) of a government agency like a GSE, FHA, or VA. Neither of these tests is difficult to meet, so neither creates a strong likelihood that the borrower will not default in the future.

For example, the underwriting standards of government agencies, particularly the FHA, are generally very loose, and are strongly influenced by both the government's desire to increase home ownership and make credit available to low-income borrowers. For example, FHA currently insures loans for borrowers with 580 FICO scores, 3 percent down payments, and 50% DTIs. In the past, loans like this were considered subprime. Now, according to the commentary accompanying the QM rule, such loans can be considered prime loans. When the borrower will not have to make a significant down payment, and could have a low FICO score, studies have shown that the likelihood of a borrower's default is high, probably around 10 percent. So, while the rule attempts to protect borrowers against overreaching by lenders, it puts in place a system that will ensure that large numbers of borrowers, who could theoretically meet their mortgage obligations at the time the loan was made, will ultimately default.

The Shadow Committee sees many other troublesome elements with the QM rule as it is currently written. The most problematic is the ease with which low quality loans can be made by lenders who only have to document the borrower's ability to repay at the time the loan is closed, but plan to securitize it. Although it would be in a portfolio lender's interest to impose strong traditional underwriting standards—particularly requiring a substantial down payment and a good FICO score to assure the borrower's *willingness* to pay—the rule makes this difficult in a competitive environment. Meeting the standards to sell the loan to a GSE or applying for FHA insurance is often a less expensive alternative for a mortgage originator, particularly in difficult market conditions. Politically driven weaknesses in these standards make it likely that a demand for low quality mortgages in the US financial system will occur again, resulting in another housing price bubble.

When such a bubble collapses, it drives down housing prices throughout the country, weakening the financial institutions that were holding these loans, causing unemployment and creating a large number of home owners whose homes are worth less than their mortgages. Moreover, to the extent that these low quality mortgages are insured or acquired by the

government agencies whose AUS judged them eligible—a likely outcome in view of the agencies’ lower costs—the taxpayers will end up paying for most of the resulting losses. The complexity and cumbersome verification requirements of the rule is likely to force smaller institutions out of the mortgage business, increasing the market share of the largest banks or other large lenders, many of which are already considered too big to fail. In a concentrated market, with fewer originators and securitizers, lenders will be able to pass many of the regulatory and verification costs forward to mortgage borrowers who make conventional down payments and have maintained high credit scores.

Accordingly, in light of its adverse effects on lenders, borrowers and the mortgage market generally, the Committee would recommend—if not the repeal of the QM rule and the corresponding provisions of Dodd-Frank—at least the elimination of those provisions of the QM rule that encourage the making and marketing of low quality loans to the detriment of almost all mortgage market participants.