Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

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We May Have A Problem, Houston*

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Well, there is a nonpartisan elephant in the room so we might as well agree on that and talk about it. The elephant is the tension that exists between trying to ensure that lenders only make good mortgage loans and trying to make more homes available for more people regardless of their financial condition. That tension is not resolved in Dodd-Frank.

For the decades that followed the Great Depression until the end of the 1990s, a home ownership ratio in the U.S. of around 63 percent to 64 percent was fairly standard. The rule of thumb promoted by lenders was that one could buy a home that was valued at about 2 to 2 1/2 times your gross annual income, with realtors trying to persuade both borrowers and lenders that 3 times annual income was OK too. Those numbers were fairly stable.

In the late 1990s and the early 2000s, those numbers rocketed upward, with home ownership numbers approaching 69 percent and borrowers buying homes that were valued at a multiple of 4 to 5 times their gross annual income. Along with that came a collapse in underwriting standards, tardy supervision by regulators and niche-spotting by lenders who found places in the regulatory world where they would not be regulated at all. The results are now well-known.

Now we are faced with the problem similar to that of the Balkan countries — there, every country believes that its natural borders are those that reflect their location at the time of their country's greatest geographical expansion. Now advocates for the Good Old Housing Days think that 69% homeownership, nothing down, and (recently) modifications if borrowers cannot make payments, represents standard operating procedures.

But unfortunately, it doesn't work that way. Congress has recognized that if we want to make the collapse of the housing finance industry less of a

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possibility in the future, we must make sure that those in the industry cannot engage in activities and practices that result in massive losses to borrowers, individual firms and the industry itself. That means that underwriting standards must be tightened, capital ratios must be increased, penalties must be enforced when the regulatory rules are broken, transparency in loans and borrower applications must exist, key players in the securitization process must be at risk for deterioration in a loan throughout the life of the loan, and rating agencies must rate without conflicts and with expertise and transparency. In other words, lenders should only provide mortgage loans to those who have the ability to repay the loans.

On the other hand, if an unstated goal of our society is that everyone has a right to a home of their own, some accommodation must be made to assist some borrowers whose resources and income are insufficient to borrow funds to buy a house under the conservative lending standards that exist to protect the society against a collapse of the housing finance market. At a minimum, loan terms and conditions must be transparent to the borrower, and steps must be taken to ensure that the borrower understands the offerings. Nevertheless, that may not be sufficient and private or public subsidies may be required to provide homes for some citizens. Yet, the perception is that the subsidy required for the needed assistance to what might be a very large number of borrowers, be it through tax policies or direct assistance, would be massive and create significant problems for the national deficit. In addition, such policies could come close to saying that the government should pay for housing for all Americans who cannot afford a home, a philosophical direction that the country has never shown signs of supporting.

The Dodd-Frank Act is the most recent statement by Congress on the subject, and that Act seems to share some of the schizophrenic positions that are reflected in the tension between two disparate goals — housing for everyone and everyone lend only what they know can be repaid.

The Act has imposed on major lenders an overlay of capital and regulations that will protect the public against costly failures, but at the same time will reduce the amount of funds they have available for any lending, be it directed at housing or for any other purpose. The share of the cost of the government expenditures for recovery from the recent crisis have been layered on them as well, thereby sapping the most energetic lenders in the country of the ability to lend at the same time public figures are clamoring for them to lend.

In housing finance directly, costs of engaging in mortgage lending have been increased in a variety of ways, including a requirement that lenders retain part of the credit risk of every mortgage made. This is designed to persuade lenders to originate safer loans. Originators must show they are qualified by passing tests and taking continuing education classes, and must pay for licenses. This is designed to ensure that only qualified brokers are operating and that those who are crooks can be tracked and removed from the system, thereby probably reducing the participants in this cost-efficient distribution system. The channel through which loans have been encouraged to be made has been narrowed to one that permits creation of only very plain kinds of loan products, made to substantial borrowers with substantial resources and limited debts. This reduces chances of failures but eliminates many potential borrowers. What were routines established to collect debts not repaid have been changed to complex loan modification programs, and have been encumbered by moratoriums and other government enforced rules that delay foreclosures to "keep people in their homes" but create other problems. Government exhortations to provide modifications have been resisted by government agencies, and by GSEs acting directly under the conservatorship of the government itself.

The Act exposes lenders and other participants to a list of potential law suits based on activities that are determined to be in conflict with vaguely worded criteria such as "abusive," "predatory," and "unfair." These standards are designed to make sure that nefarious schemes not yet seen are covered by the statute. Even if a lender or originator follows precisely the statutory language of what is described as a safe harbor in originating loans, that safe harbor protection can be rebutted and a violation found. The purposes of the Act include ensuring that responsible affordable mortgage credit remains available to consumers, and the regulators are directed to promulgate regulations that are deemed by the regulator to be necessary or proper to ensure that responsible, affordable mortgage credit remains available to consumers — a proactive regulation that conceivably could pressure lenders to make loans they don't want to make, thereby perhaps activating the question of the role of prudential regulation in the process.

Congress and the courts have prohibited lending practices that have the result of creating disparate impacts among borrowers of different prohibited classifications, even if the practices themselves are within the established regulations. Those practices must be supported by good business reasons if the impact is discriminatory, even if the treatment of borrowers is non-

discriminatory. Lenders may not discourage a borrower from going elsewhere for a loan, although what that means is undefined. While it may be a technical error in the Act, it appears that lenders must include the entire compensation paid to an in-house originator in calculating points and fees for the purposes of the points and fees triggers in high-cost loans, making it very difficult for lenders to originate anything other than high-cost loans (something that they don't want to do and many won't do).

All of this generally tends to making the return on equity in this business less than it was before, and because there currently is no requirement that any lender in the private sector must make a single residential mortgage loan if it chooses not to do so, each legislative or regulatory determination that makes it harder to make money on residential lending will in fact reduce private residential lending. The old adage is true — money is a coward. It will flow to good returns at the least possible risk.

At the same time, Congress has suggested in the Act (though not as clearly as that loans should be made only if they will be repaid) that it wants to assist in making sure that affordable housing is available not only to those with good credit and sufficient resources to qualify for a "qualified Mortgage," but to others. Regulators must promulgate regulations that will make responsible, "affordable," credit available. "Affordable" must mean something.

The consistency of the logic of these conflicting goals seems to be questionable. One answer may be that Congress intends that any loan made to any consumer will be a loan that is transparent in its terms and conditions, and that if a consumer wants such a loan, that the rules of the game to acquire such a loan for one consumer will be the same as those for any other consumer. That seems fair.

In other words, the goal that reconciles these two positions is that the borrower must be permitted to obtain a loan to buy a house if the borrower demonstrates a reasonable ability to repay the loan. The corollary of that, of course, is that the borrower does not have a right to credit if he or she cannot demonstrate the ability to repay the loan.

Dodd-Frank, however, does not place any responsibility or restrictions upon the consumer in this process, nor any statements about care that consumers must take. There is no statement that consumers should borrow only

what they can demonstrate they have a reasonable ability to repay, for example. Inclusion of a requirement such as that would have gone a long way toward resolving the conundrum that has been created by conflicting provisions in the statute, and conflicting goals, sometimes explicit and sometimes implicit.

The statute seems to reduce the chances that subprime borrowers will have easy access to the credit market for home mortgage loans. Yet, 70 percent or more of subprime borrowers of residential loans don't default, even in these distressed times. That is a lot of reliable borrowers that will find it much harder to get loans under the cautious provisions of the Act. Time has shown that they have the ability to repay the loan, notwithstanding that they would not be able to demonstrate that they pass the Qualified Mortgage test of Dodd-Frank. Lenders have known that percentages as high as this would repay loans, but because those percentages are not in the high 90s, and because they cannot tell for sure which individual borrowers will default, they must charge more to accommodate the risk in the group.

The changes which Congress included in Dodd-Frank to ensure that all borrowers are treated fairly are unlikely to change massive numbers of subprime borrowers into prime borrowers. What it has done is require more intense considerations of risk by lenders for borrowers that do not fit into a minimum risk category, most likely reduce the return on invested capital, and raise serious questions of the desirability of being in this particular lending field.

As the results of the new rules become apparent, Congress will have to revisit the provisions of Title XIV and related sections in the Act. The result of the present rules will simply tighten excessively credit availability in the residential mortgage lending sector while not resolving the tension between forcing lenders to make only safe loans and providing the greatest number of people an opportunity for home ownership.

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