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

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Mortgages and Regulations*

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With the release of the final regulations on Qualified Residential Mortgages, we near the end of the over four year period since the passage of the Dodd-Frank Act and of promulgation of most of the major residential mortgage regulations generated by that Act. Many of these will be tweaked in the years ahead, and there may even be major changes in many of them. But, at least for the first run through, we are finished. So, how do we measure them and what do we conclude?

It is fair to say that determining the success of a major regulation immediately after, or shortly after, its promulgation is difficult to do. So it is with most of these regulations; only the passage of time will finally determine their impact. A few things can be said at this point, however.

First, it is clear that the credit rules tightened long before the DFA regulations designed to tighten them were passed. Once BDP Paribus halted redemptions on its fund in August of 2007 and the trading in MBS securities froze, liquidity tightened dramatically and the heyday of the originate to sell practices was effectively ended. As with all things, it took a while and some lenders continued to dance for a while, but effectively without the ability to trade, even with efforts by the government to inject liquidity, the pace could not be sustained.

The Fed had proposed regulations tightening the worst of some of the practices as early as January of 2008, finalizing them in July of 2008 and making them effective in October of 2009. While the rules did not reach all lenders, the combination of those regulations plus the inability to find funds in the capital markets made it difficult to originate loans for most lenders, and pricing them for sales (assuming you could find a buyer) was very hard. It is not a surprise, therefore, that lenders were very cautious in lending for 30 years on the collateral that was considerably less price stable than they thought before all of this happened. The combination of the Fed rules and the market's reluctance led to lenders self-imposing most of the credit checks that later became part of the regulations promulgated pursuant to the DFA.

Second, nothing in the regulations that have been adopted have made it easier for lenders to originate loans to poor credits. The risk of lending outside the safe harbor of the QM box remains significant, even though senior officials at CFPB say it is not. We will see what success Raj Date, ex-number 2 at the

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Bureau, has with his venture into the non-QM field, but to the extent that means lending to subprime borrowers, that is not a step that most publicly held financial institutions are ready to make.

That does not mean that no non-QM loans are made. Some are. Most that are publicized are to borrowers that have very high credit scores and substantial wealth, and are frequently long standing customers of the institution. By and large, however, the regulations discourage lending to subprime borrowers, and even to borrowers that might not have been labeled subprime 10 years ago.

Third, the U.S. had a vigorous residential mortgage market before anyone had dreamed up subprime lending, hybrid ARMS, no-doc loans, negative amortization, and originate to sell. In that market, about 64 percent of the households were homeowners, a percentage that had been more or less stable for decades. Rules of thumb for purchasing a home were few but religiously followed: 20 percent to 25 percent for a down payment, and borrowing was limited to no more than two to two and a half times your annual gross income. You were offered a 30-year fixed rate mortgage.

With that system, 64 percent of households had houses,[1] and defaults were as rare as a fine Maine day in January. Lenders and the GSEs had relatively small service operations, much of which slowly became automated, and the default servicing team could fit in a phone booth.

Renting was an acceptable way to get shelter, and putting together the down payment was a difficult goal in most working families. Once you had it, however, and once you got that mortgage, it was the first thing you paid every month because not paying it would (not could, but would) lose you your home.

We are edging back toward that environment now, although our options for term and other conditions are greater, we don't necessarily have to have 25 percent down, and if we default, the rules provide second chances to keep the home. In April of 2014, the homeownership rate was back to 64 percent. Most borrowers must have substantial down payments, must document their income, do not have a myriad of options for payment amounts or timing, cannot borrow 4 or 5 times income, etc. In that environment, mortgage performance is on an upward slope. Default operations are being populated by persons servicing loans made before the credit restrictions set in. About 93 percent of all loans are current,[2] 2.4 percent of the portfolio is 30 to 59 days past due; loans in foreclosure total about 1.6 percent.[3] Of course, heavy activity continues on modifying loans made earlier during the bad old days, but that pig is being absorbed by the python over time.

Loans now being made are generally QM loans, notwithstanding the pressure from activist groups to make riskier loans.[4] With the influx of more conservative lending than in the roaring 00s, and with the lack of a robust economy that might pressure lenders to deviate from that pattern, it is doubtful that there will be a substantial change from present lending patterns in the near future.

Lenders will, of course, continue to utilize the apparent willingness of the FHA to guarantee low down payment loans, at least as long as lenders are confident that the FHA will not pass the risk back to lenders in the future for non-material reasons. Similarly, the apparent willingness of FHFA to permit the GSEs more of the risk in lower down payment loans,[5] might signal a limited door for non-QM lending to consumers with non-prime credit scores. That, too, will depend upon the scope and reliability of changes

[1] In the Wild West days of 2004, the rate was over 69 percent.

[2] Reference is to OCC regulated institutions; "Mortgage Performance Improvement Continues, OCC Report," NR 2014-129, September 25, 2014. These are about 47 percent of all mortgages outstanding in the U.S.

[3] Op. cit.

[4] See, "It's Time to End Exclusionary Lending'," Carr, American Banker, October 22, 2014.

[5] We'll have to see what the GSEs publish as their new low down payment rules — See comments of Director Watt at Mortgage Bankers Association Annual Convention, October 20, 2014.

in the Representations and Warranty Framework of the GSEs.

But the adoption of the myriad of rules following the passage of the Dodd-Frank Act only solidified in regulatory rules a pattern of lending that had been established prior to the adoption of the rules.[6] Those rules will retard backsliding on standards, and should be helpful in creating portfolios of high quality loans, but should not be helpful in providing mortgage credit to consumers similar to those higher risk consumers who obtained such credit in the 00s by taking advantage of the once in a lifetime opportunity provided by the sloppy lending, monitoring and regulatory systems. If the government wants to assume the risk of default by guaranteeing loans with very low down payment, then some consumers somewhat similar to some of those lucky ones of the past decade will be able to get loans. Absent that, it is doubtful that non-QM lending to those with low credit scores will blossom. If it does, it will not be based on the rules that have been adopted.

One other thing that seems certain – these rules will be hard to reverse while those Members of Congress in office during the 00s remain in office. There may be some nibbling on the margins, but not substantial reversals. What we have now is what we will have for a number of years.

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[6]It is only speculation that absent those rules, lending would have returned to the earlier lax patterns. Investors and lenders both have been bit by massive defaults, and lenders have suffered large litigation costs and, in some cases, have failed because of the persistent use of those patterns. The internal portfolios of lenders are insufficient to support massive housing investment.