Insight

The 5-5-5s of Dodd-Frank at 5: Episode 5

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The Problem: QM and QRM

The qualified mortgage (QM) and qualified residential mortgage (QRM) rules in Dodd-Frank were intended to make lending safer—for consumers and the financial system as a whole. Yet these rules (along with many others) drive up costs for borrowers and heap compliance burdens on financial institutions, particularly struggling community banks.

In effect, the Ability To Repay/QM rule requires a lender to certify that a borrower can repay a loan. While logic dictates that lenders, acting merely out of self-interest, would thoroughly investigate any borrower's capacity to repay, Dodd-Frank makes this directive not only legally binding but also onerous. Loans that meet certain criteria—including limitations on loan features, verification requirements, debt-to-income ratios less than 43 percent, and a 3 percent limit on points and fees—are "qualified mortgages." As such, they provide lenders a safe harbor from lending-related litigation. But by contrast, loans not meeting those requirements, non-QM loans, are now perceived as dangerous and are largely unavailable (unless made to wealthy borrowers) due to extraordinarily high legal and reputational risks. This limits financing options and credit availability, especially for lower-income borrowers.

The Credit Risk Retention/QRM rule requires securitizers to retain 5 percent of the credit risk of their mortgage-backed securities unless loans are "qualified residential mortgages." When first proposed, the QRM rule included a 20 percent down payment requirement, later withdrawn amid widespread public criticism that it would unduly restrict credit. QRM standards are now largely aligned with the QM rule except for the 5 percent credit risk retention requirement when securitizing non-QM loans. According to Boston Fed economist Paul Willen, "[R]isk retention…simply makes lenders more cautious and thus reduces the

number of defaults but at the cost of a deadweight loss to the investors and lenders." Put another way, QRM was an attempt to get more "skin in the game," but ultimately it was a policy response untethered to the root causes of the foreclosure crisis; it may give some investors more confidence, but will not prevent another housing bubble or related losses.

The Repercussion: Borrower Costs, Lender Burdens, and a Weaker Housing Market

As discussed, QM and QRM have burdened financial institutions, driving up the costs of mortgage credit for borrowers, hurting the economy, and reshaping the mortgage market.

Costly for Borrowers: A survey on lending from the American Bankers Association taken in early 2014 showed that two-thirds of respondent banks would restrict lending because of the Ability To Repay/QM rule as defined by regulators. Furthermore, 80 percent of respondents expected new regulations to measurably reduce credit availability.

Burdensome for Lenders: In that same ABA survey and others, compliance costs and regulatory burdens rank among banks' top concerns. For example, a survey of small banks by the Mercatus Center at George Mason University showed that more than 80 percent of respondents reported compliance cost increases of more than 5 percent since the passage of Dodd-Frank in 2010. Increased compliance costs include the need for outside expertise, additional staff, and time spent on additional paperwork. In the survey, many small banks reported the need to trim back or eliminate some products and perks offered to customers, especially with regard to residential mortgages, home equity lines of credit, overdraft protection, and credit cards. Some have also argued that these increased costs have resulted in higher fees for consumers, a pickup in bank mergers and market consolidation, origination volume shifts to non-banks, and a dearth of new bank charters, which is anti-competitive and may limit consumer choice. Underwriting errors can also become costly mistakes with QM and QRM. Potential litigation costs on top of compliance concerns may curtail lending to underserved and low-income communities or prove too costly for smaller financial institutions.

Bad for the Housing Recovery: Anecdotally, many market participants have expressed concerns over burdens stemming from Dodd-Frank. But the law has very real, quantifiable economic costs. An AAF report in 2012 showed the economic impact of QM, QRM, and Basel III regulations, concluding that the rules, as proposed at that time, would reduce lending and result in fewer home sales. That decrease in loans and sales negatively impacted housing starts, employment, and Gross Domestic Product (GDP). While those rules have since been altered, regulators continue struggling to balance the need to protect the safety

and security of consumers and investors while also encouraging a continued and sustainable housing and economic recovery. A more recent analysis by AAF President Douglas Holtz-Eakin looked at the economic growth implications of Dodd-Frank, specifically how all Dodd-Frank burdens—not just QM and QRM—affected savings and investment, and their linkages to growth. This research found a significant impact—roughly $895 billion in reduced GDP over the 2016-2025 period, or $3,346 per working-age person. While not solely the product of QM and QRM, these rules have limited financing options and their lengthy rulemakings created a great deal of uncertainty during the housing recovery.

The Fix: Repeal or, at the Very Least, Tweak

Recognizing that full repeal of QM, QRM, and other Dodd-Frank provisions is unlikely to overcome the threat of presidential veto, several bills under consideration in Congress would make some small tweaks with big benefits. For example, Sen. Richard Shelby's S. 1484, the Financial Regulatory Improvement Act, would allow loans that are held on a financial institution's portfolio and do not have risky features to be considered QM loans; H.R. 1210 in the House would make a similar change. The reasoning: a bank holding a loan in its portfolio has an obvious interest in thoroughly underwriting that loan and determining the borrower's ability to repay. Another change in S. 1485 would simply discontinue the practice of treating escrow payments for property insurance as part of the 3 percent limit on points and fees as they are not mortgage costs. While not getting rid of these regulations entirely, there are a number of these small changes that sensibly enhance credit availability.

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