Louisiana State University
LSU Scholarly Repository

Honors Theses | Ogden Honors College

4-2014

Qualified Mortgages: An Attempt at Residential Mortgage Stability

Andre Averill

Follow this and additional works at: https://repository.lsu.edu/honors_etd

Part of the Finance and Financial Management Commons

Recommended Citation
Averill, Andre, "Qualified Mortgages: An Attempt at Residential Mortgage Stability" (2014). *Honors Theses*. 99.
https://repository.lsu.edu/honors_etd/99

This Thesis is brought to you for free and open access by the Ogden Honors College at LSU Scholarly Repository. It has been accepted for inclusion in Honors Theses by an authorized administrator of LSU Scholarly Repository. For more information, please contact ir@lsu.edu.

Qualified Mortgages: An Attempt at Residential Mortgage Stability

By

Andre Averill

Undergraduate honors thesis under the direction of

Dr. Clifford Stephens, Ph.D.

Department of Finance

Submitted to the LSU Honors College in partial fulfillment of

The Upper Division Honors Program

April 2014

Louisiana State University

Agricultural and Mechanical College

Baton Rouge, Louisiana

Table of Contents

Abstract………………………………………………………………………………….. 2

Chapter 1: Introduction…………………………………………………………………….. 3

Chapter 2: The Housing Crisis……………………………………………………………… 5

2.1 Mortgage Backed Securities………………………………………………… 5

2.2 Increased Foreign Investment……………………………………………….. 6

2.3 Government Sponsored Enterprise Accounting Scandal……………………. 9

2.4 Private Label Securitization……………………………………………….. 10

2.5 Ratings Agencies Influence……………………………………………….. 12

2.6 Government Aided Expansion…………………………………………….. 13

2.7 The Alt-A and Subprime Market………………………………………….. 14

2.8 The More Risky Segment………………………………………………… 20

Chapter 3: The Ability to Repay Rule and Qualified Mortgages……………………... 24

3.1 Ability-to-Repay Rule……………………………………………….…..... 24

3.2 Qualified Mortgages………………………………………………………. 28

3.3 Shortcomings to the Rule ……………………………………………….…... 33

Chapter 4: Conclusion……………………………………………………………………. 39

References……………………………………………………………………………... 41

Exhibits…………………………………………………………………………………….44

Abstract

The Qualified Mortgage is the government's response to the recent mortgage crisis that led to the worldwide credit crisis. Qualified Mortgages are the most secured form of mortgage lending and prohibit many of the riskier aspects of mortgages that caused borrowers to default in the past. The purpose of this paper is to determine if Qualified Mortgages are sufficient legislation to stem the tide of poor mortgage quality and if they effectively address the problems that were present in the residential mortgage market leading up to the credit crisis. In order to determine this, a detailed explanation of the events leading to the bursting of the residential mortgage market bubble is presented. After the problems of the past are understood, I define and explain what Qualified Mortgages are and how they address and fail to address the problems leading up to the bursting of the mortgage bubble. This research finds that while the Qualified Mortgage is a step in the right direction for the damaged mortgage market, to truly fix the problems that led to the credit crisis, further legislation will be required in the future.

I. Introduction

The housing crisis of 2007 and 2008 was a shock to the American economy. Overwhelming demand for Mortgage Backed Securities, loosened mortgage underwriting standards, and a flawed perspective of housing prices all played a part in the crisis. The debacle caused the largest recession in the United States since the Great Depression, and the current market has not yet fully recovered. In response to the credit crisis, Congress passed The Dodd – Frank act of 2009. Two of the measures stemming from Dodd-Frank, the Ability to Repay Rule and the Qualified Mortgage designation, will be discussed in this research. Congress passed this new legislation in an attempt to stem the tide of poor mortgage quality and inject stability into the American housing market. In the first section of this analysis, I will try to outline the major causes of the housing bubble which ultimately lead to the credit crisis. In the next section, I discuss the ATR Rule and Qualified Mortgages. I plan to discuss what features make up a Qualified Mortgage, who the ATR Rule and Qualified Mortgages are designed to help, and the shortcomings of these new regulations. Lastly, I attempt to answer the question: is the ATR/QM Rule sound legislation capable of preventing another mortgage crisis?

The American mortgage market is characterized by a cycle of booms and busts. This aspect means that there are periods of intense growth in the prices of houses followed by a severe retraction of housing prices. According to an article published in the Economist, in the time leading up to the housing crisis, from 1997 to the housing price peak of 2006, "American house prices (not adjusted for inflation) rose 124%.[1]"

[1] "CSI: Credit Crunch." The Economist. The Economist Newspaper, 20 Oct. 2007. Web. 12 Mar. 2014.

The troubling aspect of this particular boom, as demonstrated by Exhibit 1, deals with not only its incredible length and unprecedented growth, but the fact that there were similar booms in the mortgage markets of the late 1970s and mid-1980s. These booms should have posed as useful warning signs that after a period of growth, the housing market historically tends to revert back to previous levels.

Further analysis of Exhibit 1 shows that the booms of 1970 and 1980 were characterized by inflation adjusted increases in housing prices of approximately 13% and 15% respectively. The inflation adjusted increase of housing prices from 1997 to 2006 was 88%. That means the housing boom leading up to the recent credit crisis was approximately 6.8 times greater than the boom of the 70's and 5.9 times greater than the boom of the 80's. In the following section, I attempt to explain the factors that contributed to the huge boom in housing prices and the eventual collapse of the American housing market.

II. The Housing Crisis

The housing crisis was a failure of government, private institutions, and mortgage borrowers alike. The crisis took its toll on the United States' and resulted in losses of, "at least 40 percent of 2007 gross domestic product and probably considerably more.[2]" This research analyzes the causes of the mortgage bubble that eventually burst and left the American economy in shambles. The first cause of the huge increase in housing prices was the huge increase in demand for mortgage backed securities.

Mortgage Backed Securities

Mortgage Backed Securities are investment securities that are funded by the pooling of mortgage payments. When a lender makes a loan, oftentimes these loans are purchased by another financial institution. This institution is referred to as the MBS securitizer. The payments of these mortgages are collected and pooled, and shares in these pools of mortgage payments are sold by the securitizer in the form of MBS. When investors buy MBSs, they are gradually paid back as homeowners make their mortgage payments. Essentially, an investor who buys a MBS indirectly lends money to a homeowner.[3] The purchaser of a MBS invests because they realize profits from their share of the interest payments of the mortgages. The lender sells their mortgages, because they are given cash in the transaction and are allowed to make more mortgage loans. The securitizer makes money from the price spread in the purchasing price of the mortgage and the price of the MBSs they sell. The MBS securitizer essentially acts as a

[2] Johnson, Simon. "Three Unlearned Lessons From the Financial Crisis." BloombergView.com. N.p., 26 Sept. 2013. Web. 12 Mar. 2014.
[3] "Mortgage-Backed Security (MBS)." Investopedia. Web. 13 Mar. 2014.

middleman between the borrower and investor. They are referred to as part of the secondary market place in that they do not make the original transaction of buying or selling the mortgage loan, but they buy the loans that are already made.

MBSs transfer the default risk associated with mortgages from the writer of the mortgage loan to the holder of a MBS. Once the securitizer sells the security, they no longer have to worry about whether or not the mortgages backing the MBSs are being paid back. They have made a true sale. The payments no longer go to them, but rather, are transferred to the holder of the MBS.[4]

The problem with MBSs was summarized in the economist: "By divorcing lenders from the risk of default, securitization reduced their incentives to look carefully at their borrowers: at times one side or the other, or both, descended to outright fraud. And no one, least of all financial regulators, could be quite sure who in the global financial system was on the hook for which risks."[5] The abundant securitization of MBS leading up to the crisis not only disconnected the mortgage originator from risk, but incentivized lower quality mortgages so more people could qualify and more mortgage loans could be sold to the secondary market.

Increased Foreign Investment

The demand for these MBSs was at an all-time high leading up to the crisis. This exorbitant demand can be seen as the most important driver of the mortgage bubble. The demand of the securities was driven by a huge influx of foreign investment in the securities.

---

[4] "Mortgage-Backed Security (MBS)." Investopedia. Web. 13 Mar. 2014.
[5] CSI: Credit Crunch." The Economist.

Countries like India and China had massive amounts of cash due to huge gains in their economies. A look at Exhibit 2 shows huge increases in the Gross Domestic Product of China and India in the time leading up to credit crisis. The countries, and others like them, were looking for a sound investment opportunity that offered returns on their newfound cash reserves from the huge growth in their countries' GDP. Mortgage Backed Securities offered foreign investors a historically sound investment that had consistently produced good returns. This solid reputation and historically consistent performance caused the countries to invest heavily in these MBSs. According to Jason Thomas and Robert Van Order of Washington University, "The global payment imbalances were the manifestation of 'global excess demand' for AAA securities that placed enormous pressure on the U.S. financial system and its incentives."[6] The increased foreign investment put unprecedented strain on the American securities market as a whole and MBSs were no exception.

MBSs had traditionally been seen as a safe investment and had a good reputation. They were backed by sound collateral, the house, and mortgages purchased by the secondary market were traditionally high quality. The leaders in the mortgage securitization market were two Government Sponsored Enterprises, Fannie Mae and Freddie Mac. GSEs are financing entities created by Congress to fund loans to certain groups of borrowers such as homeowners, farmers and students. Fannie Mae and Freddie Mac were created specifically to increase liquidity in the housing market by purchasing existing mortgage loans. They were the original securitizers of mortgages and were the uncontested leader in the mortgage securitization market because of an implicit government guarantee: the government would not let them fail due to their huge size and

[6] Thomas, Jason, and Robert Van Order. Housing Policy, Subprime Markets and Fannie Mae and Freddie Mac: What We Know, What We Think We Know and What We Don't Know. Diss. George Washington University, 2010. Print.

the fact that the companies were started by the government.[7] Being the uncontested leader in the secondary mortgage market allowed for Fannie and Freddie to essentially set the standards on what types of mortgages were sound enough to be bought, packaged into MBSs, and sold to the market. The GSEs historically controlled originators by establishing national standards for "conforming" loans as well as standardized documents, underwriting practices, loan products, and servicing arrangements.[8]

The standards for what mortgages Fannie and Freddie bought were extremely conservative. Most loans that were bought and securitized by the GSEs had, "a conforming loan limit of $417,000 for a one-unit property. . . Conforming loans must also meet other guidelines related to a borrower's loan-to-value ratio, debt-to-income ratio, credit score and history, documentation requirements, etc."[9] These standards led to frequent repayment of the mortgages packaged in MBSs and attributed to the securities' safe reputation. The GSEs also exercised control through contractually negotiated rights to sell back to originators loans that did not comply with GSE standards, that breached representations and warranties, and that subsequently became nonperforming."[10] This meant that the loan originator could not write just any mortgage. The originator had to make a loan that he knew the borrower would repay. If the loan was not performing as expected, the GSE was entitled to their money back as part of the representations and warranties section of the sale agreement. This ensured the loans that were purchased by the GSEs were of high quality, because if they were not, the loan originator would be the one liable for the loan. With the GSEs dominance in the MBS market and their ability to enforce the

---

[7] Pickert, Kate. "A Brief History of Fannie Mae and Freddie Mac." Time. Time Inc., 14 July 2008. Web. 19 Mar. 2014.
[8] Simkovic, Michael. Competition and Crisis in Mortgage Securitization. Indiana Law Journal, 2012. Web. 17 Mar. 2014.
[9] Smolin, Andrea. "Conforming Loan Limits - Zillow." Zillow. Web. 19 Mar. 2014.
[10] Simkovic, Michael. Competition and Crisis in Mortgage Securitization. Indiana Law Journal, 2012. Web. 17 Mar. 2014.

representations and warranties clauses of their loan purchases, there was not a complete separation of risk from originator to borrower. The lender was still liable if their mortgage did not perform. This dominance by the GSEs contributed to the safe reputations of MBSs. The GSEs understood that high loan quality was essential to a performing and marketable MBS. The MBS became more risky and created with loans of lower quality when the GSEs lost their dominate position in the mortgage securitization market.

Government Sponsored Enterprise Accounting Scandal

The deterioration of the standards set by Fannie Mae and Freddie Mac for what mortgages can be packaged into MBSs can be traced to increased competition between the Government Sponsored Enterprises and private label financial institutions. The increased competition between private label MBS securitizers and the GSEs was born out not only out of the increased demand for MBS by foreign investors, but also because the GSEs were involved in accounting scandals.

The accounting scandals of the GSEs were uncovered in 2003. At that time, "government regulators accused Freddie Mac of understating billions in profits in an effort to smooth earnings. . . The Securities and Exchange Commission ruled that Fannie Mae--the larger and more important of the two companies--had violated accounting rules, overstating profits by an estimated $9 billion since 2001."[11] In addition to misrepresenting their earnings, the companies were redistributing the hidden earnings to their executives. Franklin Raines, the CEO of Fannie Mae, was paid more than $90 million during his six years as the head of the

[11] Mclean, Bethany. "The Fall of Fannie Mae." CNNMoney. Cable News Network, 24 Jan. 2005. Web. 19 Mar. 2014.

company.[12] These scandals lead to public distrust of the GSEs and increased investment in private financial institution's MBSs. These private financial institutions' standards for the mortgages that would be packaged into MBS were much more aggressive than traditional GSE standards. With the distrust in Fannie Mae and Freddie Mac, the GSEs were placed in direct competition with private financial institutions. This competition led to a race to the bottom of mortgage underwriting standards that ended in housing crisis and economic recession of the late 2000s.[13]

Private Label Securitization

The GSE accounting scandals drove investors away from the structured and mature securitization market ruled by the GSEs to a newborn riskier market ruled by privately owned financial institutions on Wall Street. According to Exhibit 3, in 2003, total Mortgage Backed Security Issuance by the GSEs was just below 80%. The dominance by GSEs quickly fell following the accounting scandals and by the end of 2004, total MBS issuance by the GSEs was below 50%. With the GSEs' reduction of power, discipline broke down. The MBS market had lost its only clear securitization market leader capable of enforcing standards and penalizing noncompliant originators.[14]

These private investors were suddenly pushed into securitizing MBS and did not understand the complex risks associated with securitizing pools of mortgages. They saw

[12] Mclean, Bethany. "The Fall of Fannie Mae."
[13] Simkovic, Michael. Competition and Crisis in Mortgage Securitization. Indiana Law Journal, 2012. Web. 17 Mar. 2014 pg. 213
[14] Simkovic, Michael. Competition and Crisis in Mortgage Securitization. Pg 240

mortgage securitization as safe, secured lending against sound collateral.[15] This ignorance of the complex risks associated with pools of mortgages coupled with the insurance of sound collateral motivated Wall Street to buy many mortgages that were too risky to be packaged into MBSs. This purchasing of these riskier loans motivated mortgage originators to make even riskier loans and this cycle continued until the mortgage bubble proved to be unsustainable and burst.

When examining Exhibit 4, it is easy to see the reduction in quality of loans from 2003 to the peak of the housing bubble in 2006. It is clear that the two more risky mortgage segments, the subprime and the Alt-A segments, exploded when the private label financial institutions gained power in the MBS market. A subprime mortgage loan is a loan made for a borrower with a low credit score and an Alt-A mortgage loan is traditionally a loan for borrowers with a middling credit score and usually has limited documentation. Before the GSE accounting scandals in 2003, Subprime and Alt-A segments of the market made up approximately 8% and 2% of U.S. residential mortgage origination, respectively. They had such a small share of total mortgage originations due to the fact that the GSEs understood the risks associated with these mortgages and would not purchase and package them into MBSs. At the peak of the housing bubble in 2006, the subprime and Alt-A markets made up 20% and 13.5% of U.S. residential mortgage origination, respectively. That means that, in 3 years, subprime mortgages as a percentage of total mortgage origination increased by 150% and Alt-A mortgages as a percentage of total origination increased by 575%.[16] The standard underwriting for mortgages went to the wayside so more people could qualify. MBSs were being issued by inexperienced private label financial institutions with these lower quality mortgages just to feed the demand for MBS.

---

[15] Simkovic, Michael. Competition and Crisis in Mortgage Securitization. Pg 232

[16] Simple percent change analysis

Ratings Agencies Influence

The riskiness of the MBSs had increased, but due to the constant price increases of the American housing markets, the MBSs were consistently paying out to investors. Even if some homeowners could not make their mortgage payments, investors were still realizing profits. The bank would foreclose on the delinquent house, resell it, and still pay back MBS investors. This process was working due to the increased housing prices of American homes. The cycle of mortgage payment and transfer to MBS investors was never interrupted. While at the time the system was working, it was working partly based on the unsustainable price increases of American houses which can be seen in Exhibit 1.

The MBSs were increasing in riskiness, but this increase in risk went unrecognized by ratings agencies who consistently rated the securities investment grade and even AAA (the safest grade for investment instruments). There was an issue of moral hazard with the ratings agencies. These agencies were incentivized to give the MBSs investment grade ratings because the financial institutions were paying them for their appraisals. If the ratings agencies did not give the securities a good rating, the financial institutions could simply go on to another agency that would.[17] At the time, MBSs of all classifications were consistently paying out to investors. Due to this fact, a security that may be graded appropriately as BBB and backed by lower quality mortgages might be "stamped 'AAA' by helpful rating agencies."[18] The ratings agencies were taking the securities' history of solid performance based on these price increases to project the future performance of the MBSs. The ratings agencies were perpetuating a cycle of investment

[17] James, Jacoby. (2009) House of Cards [Online Video] Retrieved March 13, 2014
[18] CSI: Credit Crunch." The Economist. The Economist Newspaper, 20 Oct. 2007. Web. 12 Mar. 2014.

in MBSs by misclassifying the securities' underlying risks.[19] This misclassification of risk was another proponent of the unprecedented demand for MBSs that perpetuated the American mortgage bubble. The MBS market was not the only factor leading to the mortgage bubble, but Government expansionary policy was another reason for the explosion of the American Mortgage Market.

Government Aided Expansion

The increase in demand for MBS was not the only factor leading to the eventual meltdown of the mortgage market. There were other factors fueling the huge demand for houses. After the terrorist attacks of September 11, 2001, the American Economy was stagnant. To invigorate the economy, Alan Greenspan decided to counter the ongoing weakness by cutting the federal funds rate by 0.5%, and had a plan for future cuts of the federal funds rate to a total of 3 percentage points.[20] The federal funds rate is the rate at which banks can borrow from one another. When the Fed funds rate is lowered, overnight lending between banks is cheaper and banks are more likely to borrow from each other to meet their reserve requirements. With a lower federal funds rate, banks lend more and at lower interest rates. With cheaper bank lending, businesses expand, Adjustable-rate home loans become cheaper, and the housing market improves. With more access to borrowing, homeowners feel richer, spend more, and can take

[19] James, Jacoby. (2009) House of Cards [Online Video]
[20] "Monetary Policy Report to the Congress Pursuant to Section 2B of the Federal Reserve Act." N.p., 27 Feb. 2002. Web. 13 Mar. 2014.

out home equity loans more easily. Traditionally, homeowners use these loans to buy home improvements and new cars, stimulating the economy.[21]

With this expansionary policy, Greenspan sent mortgage rates to the lowest they had been in 30 years. With mortgage rates at a historic low, Americans were incentivized to take out mortgage loans. The huge increase in demand of mortgages due to the increase in MBS issuance coupled with further increase in demand for mortgages due to the low mortgage rates in, lead to an American housing market explosion. This explosion was not only fueled by prime and conforming loans, but also increased lending to more risky segments.

The Alt-A and Subprime Market

The subprime market consists of borrowers who simply have lower credit scores, typically below 600. Traditionally these borrowers have lower incomes and their credit suffers from their ability to repay their loans. These borrowers are inherently more risky than other borrowers. Lenders charge subprime borrowers a higher rate of interest to compensate for the increased risk.[22] Lenders know that they are lending to a lower income person who has a lower credit score and compensate for the increased risk appropriately by charging these borrowers greater interest. In the time leading up to the crisis, the subprime market exploded as demonstrated in the previous section.

Jason Guerin, the owner of Area Home Lending painted a picture of some of the subprime mortgages that were being made:

---

[21] Amadeo, Kimberly. "The Federal Funds Rate and How It Works." About.com US Economy. Web. 13 Mar. 2014
[22] "Subprime Mortgage." Investopedia. Web. 19 Mar. 2014.

> *A lot of the loans prior to the mortgage meltdown were loans for borrowers with lower credit scores. . . and just about all of those were adjustable rate mortgages, and those were typically on a 2 year fixed period. So they were amortized over 30 years, but their rate was only fixed for that 2 year period. So a lot of borrowers figured they would work on their credit score or work on showing more income, whatever their dilemma may have been that wouldn't qualify them for a conventional loan at that time. They would work on that during that 2 year period and just refinance it in year 3. A lot of them, unfortunately weren't able to get their credit fixed or weren't able to show the income they needed and they couldn't refinance as they had planned.*[23]

The example posed by Mr. Guerin addresses some of the risky lending to the subprime market. The initial interest rate on an ARM is set below the market rate on a comparable fixed-rate loan, and then the rate rises as time goes on. ARMs have a fixed period of time during which the initial interest rate remains constant, after which the interest rate adjusts at a pre-arranged frequency.[24] Some borrowers leading up to the crisis would see the initial rate on Adjustable Rate Mortgages and would be fooled into thinking that the initial low rate was the rate that they would pay through the life of the mortgage. Eventually, the rate adjusted up and the borrower could no longer afford their loan payments.

A second issue present in Mr. Guerin's example deals with lenders qualifying borrowers for loans, not necessarily because they could pay them back, but in order to build their credit scores and refinance their mortgages before the loan rate adjusted up. Leading up to the crisis, lenders were qualifying borrowers who may have had insufficient cash flow to make their payments, but qualified the borrower due to the high price appreciation leading up to the housing crisis. The lender was making the loan not based on the primary source of repayment, the homeowner's income, but rather, lenders were making loans and qualifying lenders based on the

[23] Guerin, Jason. Personal Interview

[24] McWhinney, James. "Mortgages: Fixed-Rate Versus Adjustable-Rate." Investopedia.

secondary source of repayment, appreciation of the collateral. The lender made an assumption that the borrower could sell their homes or use equity to refinance into a mortgage with a lower monthly payment.[25] Such practices proved unsustainable and eventually failed after the bursting of the mortgage bubble. These practices were ill-advised and certainly aided the mortgage bubble along, but the explosion of the Alt-A segment was really the pin that burst the mortgage bubble.

The Alt-A segment often gets lost in the shuffle when discussing the mortgage crisis. The subprime market often shoulders the brunt of responsibility for the crisis, but I contend that the expansion of the Alt-A segment had a more adverse effect on the housing market than the expansion of the subprime market. According to Dr. Joseph Mason, a finance professor at Louisiana State University, "your problem was really in the Alt-A segment. That really blew up on delinquencies much worse than any other segment, and a big portion of that, as shown in academic research, has been from second homes misreported as primary residences.[26]"

Alt-A loans are typically loans for people who are neither classified as "prime" or "subprime." They are made to people who do not qualify for the best loans, but are not low income borrowers. Alt-A loans do not typically have a set standard or given aspects and their definition is really dependent on the lender who sets their guidelines. Some typical aspects that make up the Alt-A loan are: Limited documentation, a middling credit score, high loan-to-value, flexible debt-to-income ratios, and generally, higher interest rates.[27] These loans are typically reserved for someone investing in real estate and their qualities make them the perfect real estate speculator loans. During the housing bubble years of 2004 to 2006, many home purchases and

---

[25] Palmer, Christopher. Why Did So Many Subprime Borrowers Default During the Crisis: Loose Credit or Plummeting Prices? Diss. MIT, 2013. (Pg 4)
[26] Mason, Joseph Ph. D. Personal Interview
[27] Robertson, Colin. "Alt-A Mortgages | Alt-A Lending." Mortgage Tips and Industry News. Web. 20 Nov. 2013.

home refinances were done using Alt-A loans. The borrowers did not have to show proof of income to justify the loan payments, allowing many home buyers to purchase more expensive homes than they could have purchased using a prime rate mortgage.[28]

The characteristics of the Alt-A loans makes them prime candidates for real estate speculation because these loans are so easy to acquire. Their tendency to be limited documentation loans means that income does not need to be verified, but rather stated or thrown out altogether. Higher loan-to-value (LTV) means Alt-A loans are characterized by minimal down payments. Alt-A lenders may allow 100% financing where with a prime mortgage lender, the max LTV would likely be 80% or less. A person investing in real estate would prefer no down payment because they are not purchasing the house to live in, but rather to hold on to it and realize gains from price appreciation. If an investor pays less money up front and sells the house at a greater price later, he realizes a greater the return. This concept of borrowing to realize greater profit is called leverage and was a huge factor in the eventual bursting of the mortgage bubble. The fact that they can be highly leveraged makes Alt-A loans riskier to the lender, because limited equity in the home means that a person holding a home for speculation has a natural inclination to walk away or foreclose on the property.[29] The higher interest rate on Alt-A loans did not deter real estate speculators from taking out Alt-A loans. The ethos at the time leading up to the bursting of the mortgage bubble was to quickly sell the property soon after its purchase at a higher price.

The market leading up to the financial crisis was unlike any American housing market in the past and investors made huge investments in real property because of the colossal

---

[28] Plaehn, Tim. "The Definition of Alt-A Mortgage." Home Guides. SFGate, n.d. Web. 20 Mar. 2014.
[29] Robertson, Colin. "Alt-A Mortgages | Alt-A Lending."

appreciation of housing prices. Traditionally, it is much harder to treat a home purchase as an investment because the profit opportunities for buying at the right time are just not available to the smart money that operates in the stock market. There are huge costs associated with getting in and out of the housing market, and it is not easy for most people to time the purchase of their homes to take advantage of trends.[30] This deterrence to speculating in real estate may have been true in the past American housing markets, but due to other factors described in previous sections, this was not the case in the housing market of the early 2000s. Mortgage credit was readily available and real estate speculators had much less obstruction qualifying for Alt-A mortgages and selling them quickly to realize a profit.

Loosened underwriting and the explosion of the subprime segment assisted the growth of the mortgage bubble, but the larger factor that contributed to and eventually burst the mortgage bubble was the treatment of residential real estate as investments rather than a place to live. The treatment of homes as an investment led to huge increases in Alt-A mortgage lending. In the past, before the housing bubble, "articles often tended to talk about shortages of homes for sale rather than price increases.[31]" This change in mindset led to a completely different housing market than ever before. Houses and mortgages were far more liquid and were bought and sold at an unprecedented rate.

According to Robert Shiller in his book "Irrational Exuberance," Stories abounded in the early 2000s "of aggressive, even desperate, bidding on homes, of homes selling the first day on the market for well above the asking price, and of people buying homes in a rush to beat the

[30] Shiller, Robert J. Irrational Exuberance. Princeton, NJ: Princeton UP, 2005. Pg 14
[31] Shiller, Robert J. Irrational Exuberance pg.26

market- homes that they hardly even had a chance to look at.[32]" This new, liquid housing market was something that had not been seen before and houses were selling like investment securities. The residential real estate speculator was a new type of investor and were basing their investments on the past bull market appreciation of housing prices. These speculators did not fully realize the underlying risks inherent in real estate speculation. To quote Edward Glaeser of Harvard University: "sensible models could justify high prices on the basis of seemingly reasonable projections about stable or growing prices.[33]" Glaeser contends that the real estate speculators fell victim to the same misinformed notion that lead lenders to qualify subprime borrowers for houses they could not afford: housing prices would not stop increasing.

The increase in Alt-A lending can be seen in Exhibit 4. Analysis of the exhibit demonstrates the increase in both of the more risky segments of mortgage lending: the subprime and the Alt-A. In 2003, right before the increased competition of private label MBS securitization, about 2% of all mortgages originated were Alt-A mortgages and about 8% were subprime mortgages. At the peak of the housing bubble in 2006, approximately 13.5% of mortgages originated were Alt-A and 20% were subprime. That means mortgage origination in the Alt-A segment increased by 575% and the origination of subprime mortgages increased 150% in just three years. Both of these figures demonstrate the large increase in risky mortgage lending and deterioration of underwriting standards, but the larger increase came from the Alt-A segment.

---

[32] Shiller, Robert J. Irrational Exuberance Pg. 17

[33] Glaeser, Edward L. A Nation of Gamblers: Real Estate Speculation and American History. Diss. Harvard University, 2013. Cambridge: National Bureau of Economic Research, 2013. Print.

The More Risky Segment

Lenders and new private label securitizers understood the risks they were taking when making loans to the subprime borrower. They are lower income borrowers with a poor credit history and lenders understood that they were taking a risk qualifying them for mortgages and packaging those mortgages into securities. The mortgage segment securitizers and lenders did not understand were the Alt-A borrowers. These were the borrowers who looked at a home as a disposable investment.[34]

Evidence for this lack of understanding can be seen in analysis of Exhibit 5. Exhibit 5 shows the makeup of private label MBS issuance by mortgage type in 1995 and 2005. In 1995, the Alt-A segment made up 1% of the pool of mortgages that private institutions sold as MBS. In 2005, that number jumps to 28%. The increase of subprime mortgages as part of the of the pool of mortgages bought by private label institutions increased by only 3% in the same timeframe. Privately owned financial institutions who bought mortgages in 1995 were not new entrants into the securitization market. In 1995, Fannie Mae and Freddie Mac were the leaders in securitization and these private companies understood the inherent risks of the Alt-A segment. Once Fannie Mae and Freddie Mac were out of the picture, new securitizers rushed to fill their place without knowing how risky Alt-A mortgages were. They bought, packaged and sold Alt-A loans in MBSs without understanding the segment.

Further evidence of the huge increase of Alt-A mortgages making up the MBS market can be seen when analyzing Exhibits 3 and 5 together. In 1995, the Alt-A segment made up 1% of private label securitizers pool of loans (Exhibit 5). Total MBS issuance by private label

---

[34] Reagor, Catherine. "More Homeowners Mailing Keys to Lenders." Azcentral.com. The Arizona Republic.

financial institutions was approximately $90,000,000 (Exhibit 3).[35] That means that the pool of Alt-A mortgages held by private label securitizers was worth only approximately $900,000. By 2005, private label share of MBS issuance was up to approximately $1,233,750,000 (Exhibit 3)[36] and 26% of their pool of mortgages was Alt-A loans. That means that the MBSs being issued by the private labels were backed by approximately $345,450,000 worth of Alt-A mortgages. The private label securitizers had increased their pool of Alt-A mortgages by 383.8 times in ten years.

The new private securitizers did not realize that cash flows from Alt-A mortgages are extremely risky. Real estate speculators were not buying Alt-A mortgages to make mortgage payments. Real estate speculators were buying Alt-A mortgages as an investment instrument to realize a gain on the sale of their investment. According to Dr. Mason, "The ethos at the time was, 'come to our seminar and learn how to buy 20, 30 houses, all with somebody else's money', and that's the scheme. The somebody else is the bank's money. If you go bust, it's not yours." When finally, prices of houses stopped rising, the Alt-A segment, who had put little or no money down and had little need for an asset that was declining in value simply stopped paying their mortgages. At the time, the mortgage industry was struggling to estimate how many homes are going into foreclosure because of people who don't want to pay, rather than because of people who can't afford to pay.[37]

To investors, the negative effect of simply turning in the keys to the lenders was much less than having to pay their mortgages. Their credit scores would be adversely effected, but that was better for a lot of investors who had no need for the house other than to see if it would

---

[35] Total MBS issuance= 600,000,000*.15 (private label share of MBS issuance in 1995)= 90,000,000
[36] Same process referenced in note 31
[37] Reagor, Catherine. "More Homeowners Mailing Keys to Lenders." Azcentral.com. The Arizona Republic.

appreciate in value. Instead of mailing in their monthly payment, a growing number of homeowners were simply walking away from their homes.[38]

The bubble was burst by these Alt-A borrowers who would walk away from their investments. The consequences of the Alt-A defaults were extensive. The private label securitizers had more than $345,450,000 of Alt-A mortgages on their balance sheets. These assets essentially became worthless. Once the MBSs stopped paying out, investors quickly got out of the MBS market and the private label securitizers went out of business. One of the biggest private label securitizers, Bear Stearns, was sold for $2 a share after trading at $159 a share just a year earlier.[39] When it came time for lenders to honor their reps and warranties, smaller lenders simply closed their doors and the larger lending institutions were bailed out by the American taxpayers. Neighbors of the investors who walked away were punished by lower home values due to the foreclosures.[40] This led to many people having negative equity on their houses or owing more than the value of the houses. Many properties became so far underwater, that it could take years before the home regains all of its value, if it ever does.[41]

The Alt-A borrower posed a much greater threat to the economy than the subprime borrower ever did. Once the payment of a mortgage became less than a top priority, the securities that relied on mortgage payments became worthless. Repayment of their mortgages was always a top priority for the subprime borrower. To quote Dr. Joseph Mason:

> *A lot of the problems didn't come from lower income people. If a lower income person couldn't pay their loan, they couldn't pay their loan. They got laid off from their job or something. But often, they wanted to pay their loans and they worked hard to do it, so that even once their hours*

[38] Reagor, Catherine. "More Homeowners Mailing Keys to Lenders."
[39] Thompson, Jay. "Bear Stearns Collapse: $159/share to $2 in 365 Days." The Phoenix Real Estate Guy. EXP Realty.
[40] Reagor, Catherine. "More Homeowners Mailing Keys to Lenders."
[41] Loftsgordon, Amy. "Strategic Default: When It Makes Sense to Walk Away From Your Home." Nolo.com. NOLO.

> *might have been cut back or something like that, they would try to keep making their loan payments and they might drop a credit card or sell a car.*

In response to the mortgage crisis, the government passed The Dodd–Frank Wall Street Reform and Consumer Protection Act in 2009. The aspect of Dodd-Frank that this research focuses on is the Ability-to-Repay Rule and Qualified Mortgages because of their relevance to the residential mortgage market.

III. The Ability-to-Repay Rule and Qualified Mortgages

The ATR Rule and Qualified mortgage sections of the Dodd-Frank bill attempt to reform the residential mortgage market so the events leading up to the housing crisis cannot repeat themselves. As demonstrated in previous sections, during the years preceding the financial crisis, too may loans were made to consumers without regard to their ability to repay the loans. Loans were made based on the faulty notion that housing prices would appreciate into perpetuity.[42] Loose underwriting practices- including the failure to verify a borrowers assets, debt levels and even income were allowed and unchecked. The regulations address the risky lending that was rampant leading up to the crisis and attempt to inject some stability into the market with rigorous, uniform standards of mortgage underwriting. The following sections will attempt to explain how the ATR Rule and QMs could help a subset of borrowers in a meaningful way, present some adverse effects the ATR Rule and QMs might have on residential lending, and defend the contention that the ATR Rule and QMs were premature regulations that do not address the underlying problems presented in previous sections of this analysis.

Ability-to-Repay Rule

The ATR Rule attempts to rebalance the relationship between the lender and borrower that was uneven in the time leading up to the economic crisis. The rule “fundamentally changes the U.S. residential mortgage finance market from one that is largely based on a disclosure liability standard, to one that is focused on the suitability of the loan for the borrower.[43]” The

[42] James, Jacoby. (2009) House of Cards [Online Video] Retrieved March 13, 2014.

[43] Ledig, Robert H., Ralph R. Mazzeo, and Thomas P. Vartanian. "QM Status Under the ATR Rules." Impact of Ability-to-Repay and Qualified Mortgage Rules on Residential Mortgage Loan Purchasers. Dechert, LLC.

ATR Rule requires that a lender make a reasonable, good-faith determination that the borrower has a reasonable ability to repay the mortgage loan. The lender has to consider such factors as the customer's income, assets, and employment status against not only the mortgage payment of the loan, but also against the borrower's other expenses and debt obligations. The lender also has the obligation to check the borrower's credit history. The ATR Rule also limits prepayment penalties. Prepayment penalties are instruments used by lenders to offset the loss of interest income due to the early retirement of the mortgage. In this way, the rule incentivizes the borrower to repay the mortgage as soon as they have the ability.

The ATR Rule explicity includes eight underwriting factors that lenders must evaluate prior to the consummation of a loan. These factors include:

> *1. Current or reasonably expected income or assets (other than the value of the property that secures the loan) that the consumer will rely on to repay the loan*
> *2. Current employment status (if you rely on employment income when assessing the consumer's ability to repay)*
> *3. Monthly mortgage payment for this loan. You calculate this using the introductory or fully-indexed rate, whichever is higher, and monthly, fully-amortizing payments that are substantially equal*
> *4. Monthly payment on any simultaneous loans secured by the same property*
> *5. Monthly payments for property taxes and insurance that you require the consumer to buy, and certain other costs related to the property such as homeowners association fees or ground rent*
> *6. Debts, alimony, and child-support obligations*
> *7. Monthly debt-to-income ratio or residual income, that you calculated using the total of all of the mortgage and non-mortgage obligations listed above, as a ratio of gross monthly income*
> *8. Credit History*[44]

[44] "Small Entity Compliance Guide." Ability to Repay and Qualified Mortgage Rule. Consumer Financial Protection Bureau

Essentially, lenders must now super check a prospective borrower's financial situation, documentation, verification, and confirmation to assess whether the borrower falls within the prescribed level of risk and truly have the ability to pay back the loan being made to them.[45]

The rule attempt to curtain any uncertainty involved in originating a residential mortgage loan. The borrower must have enough income or assets to be able to satisfy the mortgage payments on the loan. This seems like common sense, but leading up to the mortgage meltdown, there was an unprecedented amount of risky loan originations specifically in the subprime and Alt-A markets. The analysis of Exhibit 4 and the example posed by Jason Guerin proves that lenders were making loans without consideration of the borrower's financial situation. In this regard, the ATR Rule seems to be a step in the right direction for the residential mortgage market. The ATR Rule forces common sense underwriting back into the mortgage market. The market leading up to the crisis, fueled by demand for MBSs, was about the volume of loans lenders could write rather than the quality of loans the lenders were writing. The ATR Rule simply puts a lender back on track and back to the basics of mortgage underwriting.

A second aspect of the ATR Rule states that a lender cannot use a "teaser" rate to qualify a borrower for a loan. In the situation posed by Jason Guerin, the lender would qualify a borrower based on the initial lower rates of an adjustable rate mortgage. The borrower had the ability to make the initial mortgage payments at the lower rate, but when the interest rate adjusted up in the next period, the mortgage payments would jump to unaffordable levels. Jason explained the reason lenders and borrowers might engage in these loans was to increase the borrower's credit score so that they might be able to qualify for a higher quality loan or refinance the loan due to the borrower's improved credit score. These loans seemed less risky at the time due to the high levels of price appreciation of the housing market. The ATR disallows these

[45] Greene, Mark. "The Great And Powerful New Ability-To-Repay Rule." Forbes. Forbes Magazine,

types of loans and states that the lender must consider the rate increases of adjustable rate mortgages to qualify a borrower for the mortgage. The reason many borrowers gave in these ex-post interviews as to why they could no longer afford their mortgage payments was on the basis of these steep payment increases.[46] The ATR Rule will provide aid to these financially illiterate borrowers who did not understand that a small increase in the interest rate could drastically increase their mortgage payments.

Another aspect of the residential mortgage lending market that the ATR Rule changed is a borrower's legal recourse against a lender. Prior to the ATR Rule, borrower rights under the Truth in Lending Act ("TILA") focused on disclosure issues. Under TILA and the ATR Rule, borrowers will now have rights based on suitability issues[47]. This means that before the ATR Rule, the lender was not liable for a borrower's inability to pay their mortgage. With the rule in place, the borrower can sue a lender for not properly assessing their ability to repay the mortgage. The lender now has the legal obligation to thoroughly check the borrower's documentation and verify all of the underwriting standards of the ATR Rule are addressed. If the lender has not properly assessed the borrower's ability to repay and the borrower goes into default, the borrower can sue the lender for damages. Under the ATR Rule, there is a subset of loans that offer lenders legal protection against borrower lawsuits; these loans are called Qualified Mortgages. While all loans currently being originated must be ATR Loans, Qualified Mortgages are a distinct segment and are the most secured form of mortgage loans.

---

[46] Mason, Joseph PhD. Personal Interview.

[47] Ledig, Robert H., Ralph R. Mazzeo, and Thomas P. Vartanian. "QM Status Under the ATR Rules."

Qualified Mortgages

The QM designation creates a class of mortgages characterized by the most stable loan features. QMs have numerous characteristics and are broken down into three distinct segments. The first segment, the Safe Harbor QM, is the safest loan a borrower can obtain. The second segment, the Rebuttable Presumption QM, has the same stable features as a Safe Harbor QM, but costs more to the borrower due to its higher interest rate. The last segment, the Government Related QM, relaxes some of the standards that would not qualify it as a Safe Harbor QM, but still possesses many of the stringent underwriting standards and stable features of a Safe Harbor QM.

The Safe Harbor QM provides the largest assurance of loan repayment. To be designated a Safe Harbor QM, the rate of interest charged cannot exceed the average prime offer rate ("APOR") by 1.5% and a loan must meet the following requirements:

1. *Have regular periodic payments that are substantially equal, subject to interest rate adjustments;*
2. *Do not have negative amortization;*
3. *Do not defer principal;*
4. *Have no balloon payments;*
5. *Points and fees may not be excessive (those exceeding 3% of the total loan amount on a loan exceeding $100,000);*
6. *Term cannot exceed 30 years;*
7. *Must be underwritten based on the maximum interest rate during the first five years;*
8. *Must be based on verified current or reasonably expected income or assets and current debt obligations and child support; and*
9. *Monthly debt-to-income ("DTI") ratio may not exceed 43% as calculated under the ATR Rule's*[48]

The Safe Harbor QM takes the initial ATR Rule and makes the underwriting standards even more stringent and prohibits certain riskier loan aspects. The disallowance of negative amortization, deferred principal, balloon payments, and making the loan underwritten based on

[48] Ledig, Robert H., Ralph R. Mazzeo, and Thomas P. Vartanian. "QM Status Under the ATR Rules."

the maximum interest rate during the first five years all have to do with the previously discussed jump up in payments to unaffordable levels.

Negative Amortization happens when a borrower pays less than the interest they owe for the payment period. When this occurs, the deferred interest (the amount of interest the borrower did not pay) gets added to the principle of the loan balance. A financially illiterate person unaware of how negative amortization works might be shocked into a huge jump up in mortgage payments when the rate of an adjustable rate mortgage not only increases due to the rate adjustment, but also due to the fact that they owe more money than when they initially took out the loan because the loan principle has increased. QMs disallow negative amortization because it enables a borrower to think they are paying off their loan when really, not only are they not paying the loan, they owe more money than when they started making payments.

Deferred principle can be seen as similar to negative amortization in the fact that a borrower is not gaining any ground on their mortgage payments. The payments the borrower makes when the borrower defers principle are “interest-only’ payments and can again lull a financial illiterate person into thinking they are decreasing their debt when really they are just putting it off to be paid later.

Balloon payment loans are short term loans that are not fully amortized and at the end of the loan term, the balance of the loan comes due and the borrower must pay the balance of the loan in one lump sum. These loans typically reserved for a borrower well versed in finance and can be attractive for a short term borrower due to their lower interest rates. Someone unaware of how balloon payment loans work may not be able to pay the large lump sum payment at the end of the loan term and might be required to refinance or default on the loan.

The requirement that the loan be underwritten based on the maximum interest rate for the first five years directly effects the segment of subprime borrowers described in Mr. Guerin's example. This restriction takes the "teaser" rate requirement of the ATR rule and puts it in more definable, concrete terms. The borrower can no longer qualify at the lowest rates offered by their ARMs and a lender must make sure that the borrower can pay not only the initial rate, but the maximum rate allowed. This eradicates lending to borrowers hoping to raise their credit scores and refinance, but rather emphasizes a borrower's compatibility with the loan being written.

The other two criteria that define QMs: the 3% cap on points and fees charged to a lender and the 43% debt to income ratio are also in place to protect the borrower. The first criteria, the 3% cap on points and fees for loans above $100,000 essentially protects the borrower from originator greed. Leading up to the mortgage meltdown, the mortgage originator had too much power. The demand for mortgages was exorbitant and mortgage brokers were charging a borrower high fees to originate their loans. When discussing the issue with Mike Anderson, the president of Essential Mortgage Company, he said, "our industry needed a cleansing. . . there's nothing wrong with making money, but don't take advantage.[49] The second criteria, the 43% debt to income ratio, protects borrowers from themselves. This safeguard acts to inhibit a borrower from taking on more debt than they can handle. Too much debt can overburden a borrower and a borrower's ability to repay the mortgage.

Safe Harbor QMs offer a lender with the highest standard of legal protection. All qualified mortgages are assumed to be in compliance with the ATR Rule. Failure to adhere to the ATR Rule will result bring legal action upon a lender in the form of an ATR Rule violation. An ATR Rule Violation simply means that a lender failed to comply with some part of the ATR underwriting standards. A lender who originates a Safe Harbor QM will be more protected from

[49] Anderson, Mike. President, Essential Mortgage Company.

a borrower lawsuit. This form of QM puts the burden of proof of an ATR Rules Violation onto the borrower. The way a court looks at a QM is different than that of a Rebuttable Presumption QM and other loans. The Safe Harbor QM makes a lender innocent until proven guilty. A lender who originates a QM Safe Harbor will have much less time and hassle associated with borrower lawsuits.[50]

The next segment of QMs, the Rebuttable Presumption QM, requires all of the underwriting standards of the ATR Rule and Safe Harbor QMs and they must comply with all of the stable loan characteristics defined by the Safe Harbor QMs. The main difference between Safe Harbor QMs and Rebuttable Presumption QMs is that Rebuttable Presumption QMs have a rate of interest that exceeds the APOR by 1.5% or more.

Being a higher cost loan inherently makes a Rebuttable Presumption QM more risky than a Safe Harbor QM. For this reason, if a borrower brings an action upon a lender for an ATR Rules Violation, the court looks at the lawsuits differently. Even if a Rebuttable Presumption loan meets the standard QM requirements, a borrower can still challenge the QM treatment of the loan by demonstrating that specified obligations of which the creditor was aware at the time of consummation of the loan, would leave the borrower with insufficient residual income or assets to meet living expenses. If the borrower is successful in such a claim, the borrower will likely seek to challenge the compliance of the loan with the ATR Requirement.[51] The lender has to defend itself that they properly assessed the borrower's ability to repay the mortgage when originating a Rebuttable Presumption QM. This type of QM puts the lender at more risk and exposes them to more ATR Rules Violation lawsuits.

[50] Consumer Financial Protection Bureau. Shopping for a Mortgage? What You Can Expect under Federal Rules.
[51] Consumer Financial Protection Bureau. Shopping for a Mortgage? What You Can Expect under Federal Rules.

Government Related QMs are loans that are eligible to be purchased, guaranteed, or insured by certain government entities, including the Federal Housing Administration, Fannie Mae, or Freddie Mac. These Government related QMs are the same as Safe Harbor and Rebuttable Presumption QMs in all aspects except that they do not have to meet the 43% maximum debt to income ratio that applies to standard QMs. The ability of Fannie Mae and Freddie Mac to purchase these Government related QMs is in effect as long as they remain in government conservatorship. After the government is no longer involved in the companies, Fannie Mae and Freddie Mac's future purchases of loans will be limited to loans that are Qualified mortgages under the Ability-to-Repay Rule (Rule), including those meeting the special or temporary qualified mortgage requirements under the Rule.[52] Once the government relinquishes control back to the companies, "the 43% debt to income ratio will be the law of the land.[53]" These Government related QMs provide lenders with the same legal protection and presumption of compliance with the ATR Rule as the Rebuttable Presumption QMs.

There are four new classes of loans that stem from directly from the implementation of the ATR/QM Rule. They are: (1) Non-Qualified Mortgage, (2) Safe Harbor QMs, (3) Rebuttable Presumption QMs, and (4) Government Related QMs. As a whole, the number one priority of these new segments of loans is to protect the mortgage borrower. They aim to protect the borrower from toxic loan features, the mortgage lender, and even, the borrower themselves. The ATR/QM Rule provisions specifically look to address the issues associated with lending to less educated and financially illiterate segment. It also empowers borrowers by making it easier to bring legal action upon the lender. These regulations could be meaningful in protecting and empowering the financially illiterate person wanting to buy a home, but at what cost?

---

[52] Feliciano, Melainie A. "Fannie Mae/Freddie Mac Announce Policy on Qualified Mortgages"
[53] Anderson, Mike. Personal Interview.

Shortcomings to the Rule

This research finds many flaws in the ATR/QM rule. The government enacted Dodd-Frank and the ATR/QM rule with good intentions: to empower and protect the mortgage borrower. The problem with the new regulations is that the government failed to understand the unintended adverse effects these regulations will have on the residential mortgage market. The Consumer Financial Protection Bureau created and enacted these rules without fully understanding the market. According to the president of Essential Mortgage Company, "The CFPB came out of Dodd Frank and they don't understand the mortgage business.[54]" This new regulation is not good for the mortgage market and the following pages will shed light on some of its flaws

The new rules have tremendously increased the costs of new lending and some of these costs are passed on to the borrower.[55] Mortgage originators have to check, verify, and confirm all of the borrowers financial information to be sure they are in compliance with the ATR Rule. The compliance costs associated with the new regulations are extremely high. Lenders also have more documentation requirements due to the regulations and this significantly slows down their business. Whereas an underwriter used to be able to make 10 to 15 loans a day, today, that same underwriter can maybe do one or two loans a day. . . The whole process takes longer, there is more paperwork, and the general cost to do business goes up.[56] Lending institutions have had to hire whole new departments just to make sure they comply with these new rules. These lending institutions they are not just absorbing all of these new expenses, they are passing some of them on to the buyer.

---

[54] Anderson, Mike. President, Essential Mortgage Company.Personal Interview.
[55] Guerin, Jason. Owner, Area Home Lending. Personal Interview.
[56] Anderson, Mike. President, Essential Mortgage Company. Personal Interview.

Another factor that increases the total cost of lending and slows the whole process is this new threat of legal action taken by borrowers against lending institutions. As previously mentioned, the ATR Rule essentially moves the lender's personal accountability from a simple disclosure to a case by case investigation of compliance with the ATR standards. Under the ATR Rule, lending institutions that are seeking to foreclose on a loan will experience substantial increases in expenses and processing delays in connection with the foreclosure process. If borrower is able to make a strong ATR Rule violation claim, the borrower may be able to effectively prevent a foreclosure and may be able to renegotiate the terms of their loans.[57] A defaulting borrower is aided by the ATR Rule in slowing the foreclose process. This slowing of the foreclosure incentivizes lawsuits for ATR Rule Violations. The defaulting borrower will desire to stay in their homes as long as possible and a lawsuit is the perfect instrument to delay a foreclosure. In addition to new compliance departments, financial institutions will have to hire legal departments to argue loan suitability issues in court. All of these increased expenses are being passed on to the borrower and drying up the mortgage origination market.

The increased probability of lawsuits due to the ATR/QM Rule, not only increase the lender's expenses, but also decrease the supply of quality loans to qualified borrowers. According to Mike Anderson, "a lot of lenders will not make a loan with a rebuttable presumption. There's too much risk. It's a safe loan to make but people just aren't making them because of the rebuttable presumption.[58]" Rebuttable Presumption QMs are extremely likely to be repaid due to the stringent underwriting standards and stable loan characteristics they contain, but some lenders are not making the loans. The reason lenders aren't making Rebuttable Presumption QMs is due to the increased risk of legal action taken against them. The regulation

[57] Ledig, Robert H., Ralph R. Mazzeo, and Thomas P. Vartanian. "QM Status Under the ATR Rules."
[58] Anderson, Mike. President, Essential Mortgage Company. Personal Interview.

has transferred the risk of default completely from the borrower and given it to the lender with the increased risk of lawsuits. In this way, the regulation is actually cannibalizing itself because some of the supply of high quality loans (which the regulation sets out to achieve) are actually being decreased due to this government generated legal risk.

Another way in which the regulations do not achieve their goals has to do with the 3% cap on points and fees charged to the borrower for loans over $100,000. The goal of the ATR/QM rule is to protect financially illiterate, less educated, lower income borrowers. The regulation does protect them from not being able to make mortgage payments, but due to the 3% cap on points and fees it will actually decrease the supply of loans to lower and middle class borrowers. Due to the huge increase in compliance costs discussed above, the lender has to increase their compensation and charge the borrower a greater fee to realize profit. The borrower needs to pass on both this increased cost to do business as well as the normal fees that come with originating a loan. Typical fees the lender has to account for when originating a loan are: finance charges, real-estate related charges, creditor-paid charges, ect.[59] All of these loan origination charges plus the increased charge for the loan owner's compensation to offset increased expenses all have to be fit into 3% of the total loan amount.

Due to the 3% cap, typically on smaller loans, the lender is unable to fit in all of the normal fees associated with a loan as well as their increased rate of compensation to offset new expenses. Lenders are not offering mortgages to the lower income and subprime borrower not only because their underwriting standards have gone up, but because they can no longer make money off of these smaller loans. Again the rule seems to be cannibalizing its own goals. "Its

[59] "Small Entity Compliance Guide." Ability to Repay and Qualified Mortgage Rule.

decreasing the supply of loans to the very segment it aims to protect. That's the unintended consequences."[60]

Another large issue that the regulation has created deals with Government Related QMs. Currently, while Fannie Mae and Freddie Mac remain in conservatorship, lenders can originate loans with a higher ratio of debt to income than the 43% permissible by QMs. Once the government gives control back to the GSEs, however, lenders might no longer make these loans because they do not want the added risks associated with writing Non-Qualified loans. The 43% seems arbitrary and after the government leaves the GSEs to fend for themselves, what will happen to the high quality borrowers with DTI ratios just above 43%? According to President Anderson there will be "a ton of buyers with 45% debt to income that are high quality buyers that are going to be shut out. They are going to have to go to a private company . . . and instead of paying a 4.5% rate they are going to have to pay a 7 %or 8% rate. That's huge."[61] Exhibits 6 and 7 display two 30 year, fully amortized, fixed rate mortgages for a mortgage with a loan value of $350,000. Exhibit 6 shows the mortgage based on the 4.5% interest rate that Mr. Anderson gave as an example of what the rate for a QM might be. To summarize the amortization chart, the monthly payments the borrower would make at this rate are $1,773.40 and the total interest paid over the life of this loan is $288,423.49. Exhibit 7 shows the mortgage based on the 8% rate that a lender might charge to overcome the risks of Non-Qualified mortgage lending. This loan's monthly payments were $2,568.18 and the total interest the borrower would pay over the life of this loan is $574,543.36.

The difference in 3.5% for a mortgage makes a tremendous difference in both the amount paid per month and the amount of interest paid over the life of the loan. The Non-Qualified

---

[60] Anderson, Mike. President. Essential Mortgage Company. Personal Interview.

[61] Anderson, Mike. President. Essential Mortgage Company. Personal Interview.

mortgage had 44.8% larger monthly payments and paid 99% more interest or $286,119.87 more in interest over the life of the loan. That constitutes an unsustainable contrast in interest payments for a borrower with a 45% DTI ratio who doesn't meet the QM standards and a borrower with a 43% DTI ratio who qualifies for a QM.

This potential discrepancy in mortgage costs between lenders with only slight differences in their debt to income ratios could cause huge outrage by borrowers who do not meet the standards for Qualified Mortgages. According to President Anderson of Essential Mortgage Company, we are going to see some backlash from the strict rules in the near future. He said, "I guarantee you a year from now, we are going to be seeing Congress go, 'what did we do?' Their constituents are going to be screaming bloody murder because they can't get mortgages. Minorities are going to be screaming because they can't get mortgages. It's going to be tough."[62] According to Mr. Anderson, not only will the people who are off on their debt to income ratios going to be upset that they don't meet the standards for Qualified Mortgages, but more minority borrowers will not be able to meet the QM standards as well.

Exhibit 8, which polls responses from 997 low and middle income American households, shows that African American and Latino respondents are more likely to report worse credit scores than white households. According to the exhibit, approximately 24% of lower to middle income white households reported having excellent credit scores while approximately 12% of Latino households and 7% of African American households reported to having excellent credit scores. With the stringent new laws on who qualifies for QMs and with minority households having worse credit scores than that of white households, many of the people being turned away for mortgage loans will be minorities. This issue is one reason why QMs will prove to be an unsustainable new criterion for mortgage lending.

---

[62] Anderson, Mike. President. Essential Mortgage Company. Personal Interview.

Traditionally, the government has passed many laws that have aimed to increase the supply of mortgage lending to minority and lower income households. Two examples of legislation aimed at this Congressional goal are the GSE Act and the Equal Credit Opportunity Act. The GSE Act of 1992 mandated that a specified percentage of Fannie Mae and Freddie Mac purchases come from underserved and minority populations.[63] The Equal Credit Opportunity Act prohibits credit discrimination on the basis of race, color, religion, national origin, sex, marital status, age, or because you get public assistance.[64] Both of these laws aim to provide an increased supply of credit to minorities and it seems that the ATR/QM rule directly conflicts with this goal. When minorities are being turned away due to their lower credit scores politicians will want to address the problem and loosen the regulations of the ATR/QM Rule. Not only does the new legislation have many shortcomings, it will likely have to be amended or thrown out by Congress when public outcry for mortgages becomes too great.

---

[63] Moulton, Shawn. "The 1992 GSE Act and Loan Application Outcomes."
[64] "Consumer Information." Your Equal Credit Opportunity Rights.

IV. Conclusion

The Ability to Repay and Qualified Mortgage Rules do not address the underlying problems that lead to the housing bubble and eventually the Great Recession. The rules appear to cater to the financially illiterate and subprime borrowers who were only a portion of the problem contributing to the housing crisis. The legislation fails to address the Alt-A segment of mortgages who were substantial contributors in the creation of the mortgage bubble. It also fails to address the underlying macroeconomic factor that contributed to the bubble: the misrepresentation of risk associated with Mortgage Backed Securities. The huge influx of demand for MBSs and the privatized securitization of the MBSs was the reason that these subprime and Alt-A loans were being originated. To solve this problem, legislators must address the problems associated with MBS securitization rather than the loans that are created from an increase in MBS securitization. The legislation creates more new problems for mortgage lenders while not fixing glaring old problems that lead to the mortgage bubble.

These new rules will also create a market for Non-Qualifed Mortgages that will be more costly to borrowers. Currently lenders are not willing to accept the risks associated with making Non-Qualified Mortgages. Once lenders see that there is a huge market for people who do not meet the standards for QMs, they will start to supply this segment of borrowers with new mortgage products that do not exist in today's marketplace and are not encompassed by the new regulations. According to Dr. Mason, the new rules are "not going to substantially heed the ability to sell non-qualified mortgages in the market."[65] Once the market starts catering to this unsupplied segment and starts making Non-Qualified Mortgage loans, the process of securitizing these loans will exist once again.

[65] Mason, Joseph Ph. D. Personal Interview

To fix the problems in the residential mortgage market that lead up to the financial crisis Congress needed to think harder about what the problems were before they enacted the ATR/QM Rule. The ATR/QM Rule is premature action and a mistake by the government. Congress acted to rectify a problem before they understood the underlying causes. I believe a future mortgage bubble can be built back up and that the ATR/QM Rule is unsound legislation incapable of preventing another mortgage crisis.

References

Amadeo, Kimberly. "The Federal Funds Rate and How It Works." About.com US Economy. Web. 13 Mar. 2014

Consumer Financial Protection Bureau. Shopping for a Mortgage? What You Can Expect under Federal Rules. Consumer Financial Protection Bureau, Print.

"Consumer Information." Your Equal Credit Opportunity Rights. Federal Trade Commission, Web. 02 Apr. 2014.

"CSI: Credit Crunch." The Economist. The Economist Newspaper, 20 Oct. 2007. Web. 12 Mar. 2014.

Feliciano, Melainie A. "Fannie Mae/Freddie Mac Announce Policy on Qualified Mortgages | Mortgage News | Daily National and State Headlines." *Fannie Mae/Freddie Mac Announce Policy on Qualified Mortgages | Mortgage News | Daily National and State Headlines*. Mortgage Professional Magazine, 14 Oct. 2013. Web. 25 Oct. 2013.

Glaeser, Edward L. A Nation of Gamblers: Real Estate Speculation and American History. Diss. Harvard University, 2013. Cambridge: National Bureau of Economic Research, 2013. Print.

Greene, Mark. "The Great And Powerful New Ability-To-Repay Rule." *Forbes*. Forbes Magazine, 25 Jan. 2013. Web. 27 Oct. 2013.

Ledig, Robert H., Ralph R. Mazzeo, and Thomas P. Vartanian. "QM Status Under the ATR Rules." *Impact of Ability-to-Repay and Qualified Mortgage Rules on Residential Mortgage Loan Purchasers*. Dechert, LLC., Oct. 2013. Web. 27 Nov. 2013.

James, Jacoby. (2009) *House of Cards* [Online Video] Retrieved March 13, 2014, from <http://hulu.com/watch/59026>

Johnson, Simon. "Three Unlearned Lessons From the Financial Crisis." BloombergView.com. 26 Sept. 2013. Web. 12 Mar. 2014.

Loftsgordon, Amy. "Strategic Default: When It Makes Sense to Walk Away From Your Home." Nolo.com. NOLO,Web. 20 Mar. 2014.

Mclean, Bethany. "The Fall of Fannie Mae." CNNMoney. Cable News Network, 24 Jan. 2005. Web. 19 Mar. 2014.

McWhinney, James. "Mortgages: Fixed-Rate Versus Adjustable-Rate." Investopedia. 04 June 2012. Web. 04 Apr. 2014.

"Monetary Policy Report to the Congress Pursuant to Section 2B of the Federal Reserve Act." N.p., 27 Feb. 2002. Web. 13 Mar. 2014.

"Mortgage-Backed Security (MBS)." Investopedia. Web. 13 Mar. 2014.

Moulton, Shawn. "The 1992 GSE Act and Loan Application Outcomes." Diss. University of Notre Dame, Abstract. Print.

Palmer, Christopher. Why Did So Many Subprime Borrowers Default During the Crisis: Loose Credit or Plummeting Prices? Diss. MIT, 2013. Print.

Plaehn, Tim. "The Definition of Alt-A Mortgage." Home Guides. SFGate, n.d. Web. 20 Mar. 2014.

Pickert, Kate. "A Brief History of Fannie Mae and Freddie Mac." Time. Time Inc., 14 July 2008. Web. 19 Mar. 2014.

Reagor, Catherine. "More Homeowners Mailing Keys to Lenders." Azcentral.com. The Arizona Republic, 21 Apr. 2008. Web. 20 Mar. 2014.

Robertson, Colin. "Alt-A Mortgages | Alt-A Lending." Mortgage Tips and Industry News. Web. 20 Nov. 2013.

Shiller, Robert J. Irrational Exuberance. Princeton, NJ: Princeton UP, 2005. Print

Simkovic, Michael. Competition and Crisis in Mortgage Securitization. Indiana Law Journal, 2012. Web. 17 Mar. 2014.

"Small Entity Compliance Guide." *Ability to Repay and Qualified Mortgage Rule*. Consumer Financial Protection Bureau, 12 Oct. 2013. Web. 25 Oct. 2013.

Smolin, Andrea. "Conforming Loan Limits - Zillow." Zillow. Web. 19 Mar. 2014.

"Subprime Mortgage." Investopedia. Web. 19 Mar. 2014.

Thomas, Jason, and Robert Van Order. Housing Policy, Subprime Markets and Fannie Mae and Freddie Mac: What We Know, What We Think We Know and What We Don't Know. Diss. George Washington University, 2010. Print.

Thompson, Jay. "Bear Stearns Collapse: $159/share to $2 in 365 Days." The Phoenix Real Estate Guy. EXP Realty, 17 Mar. 2008. Web. 21 Mar. 2014.

Exhibit 1

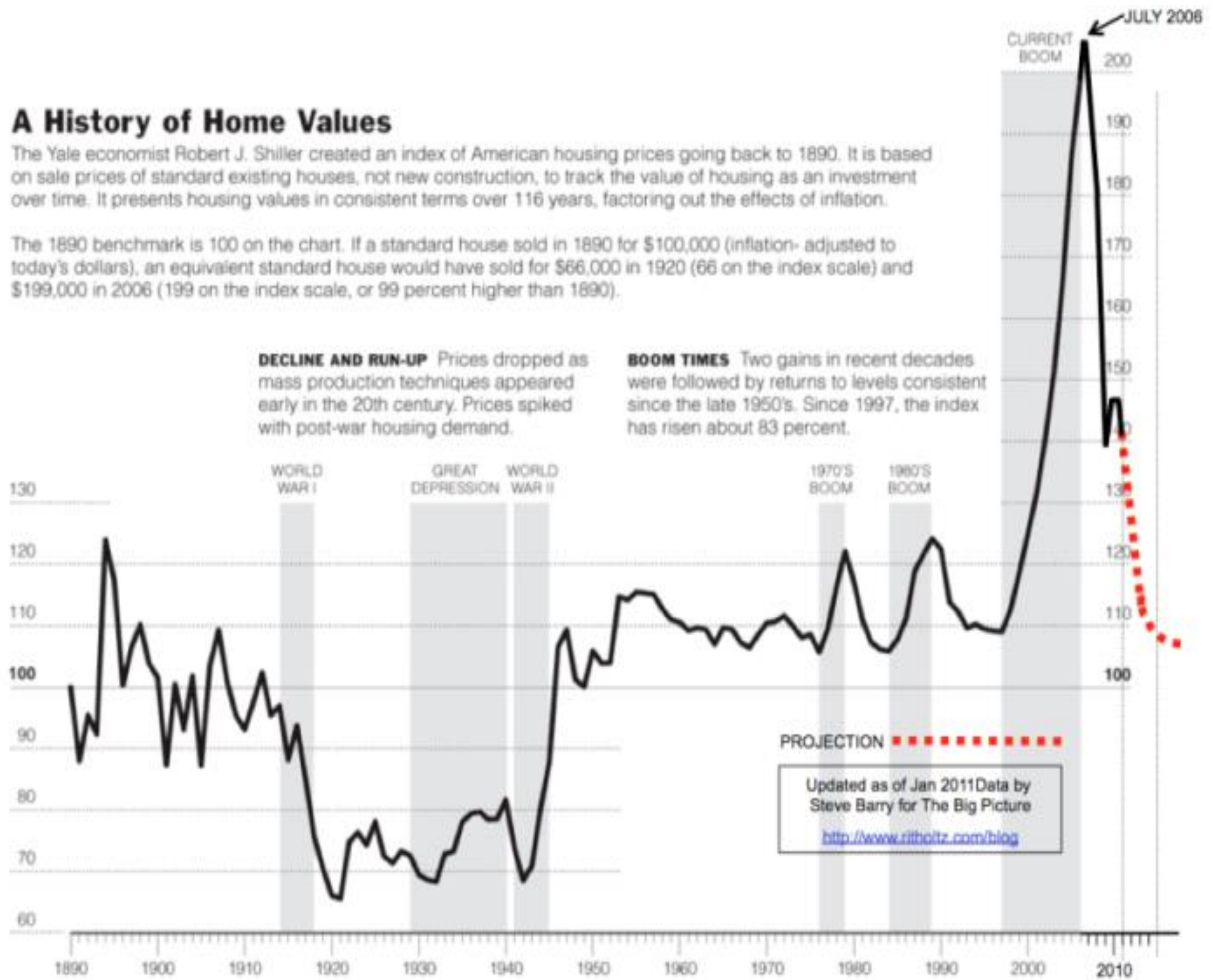
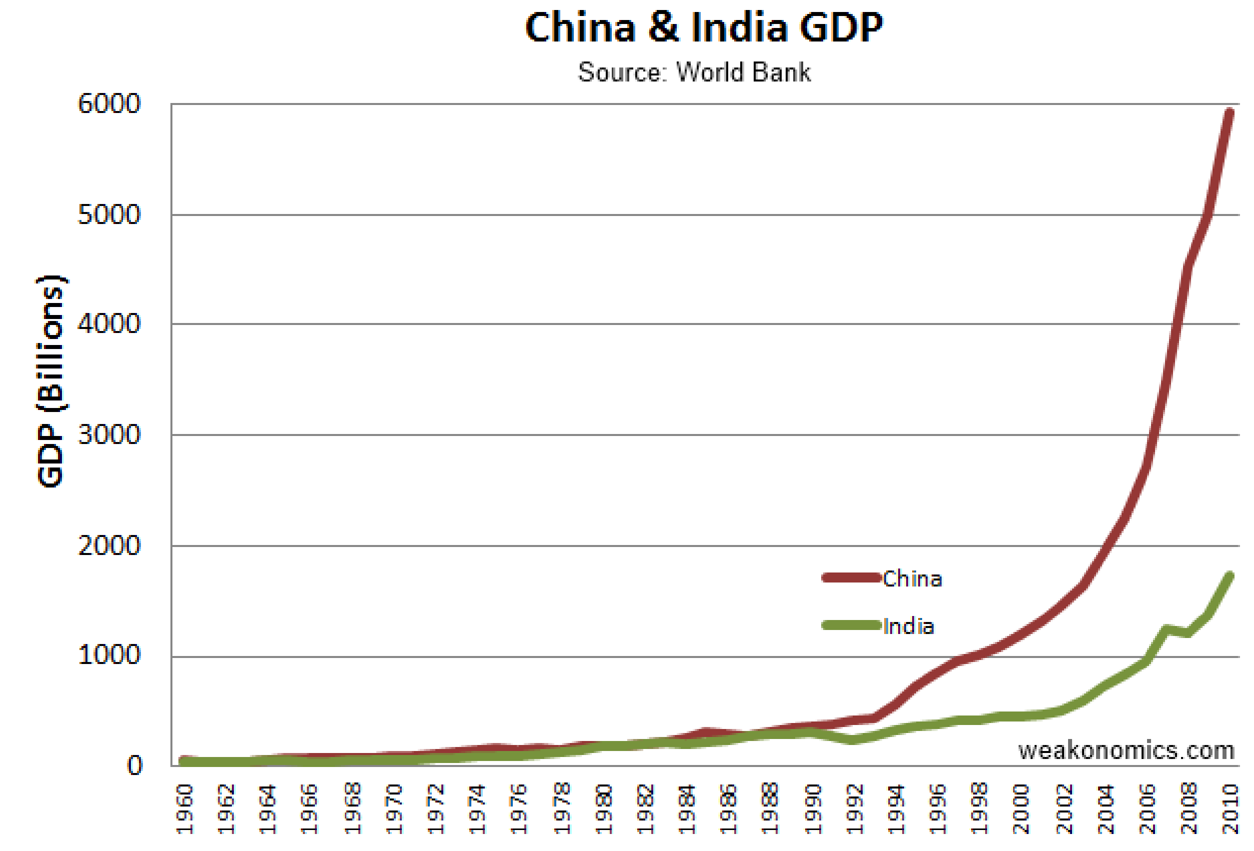


Exhibit 2

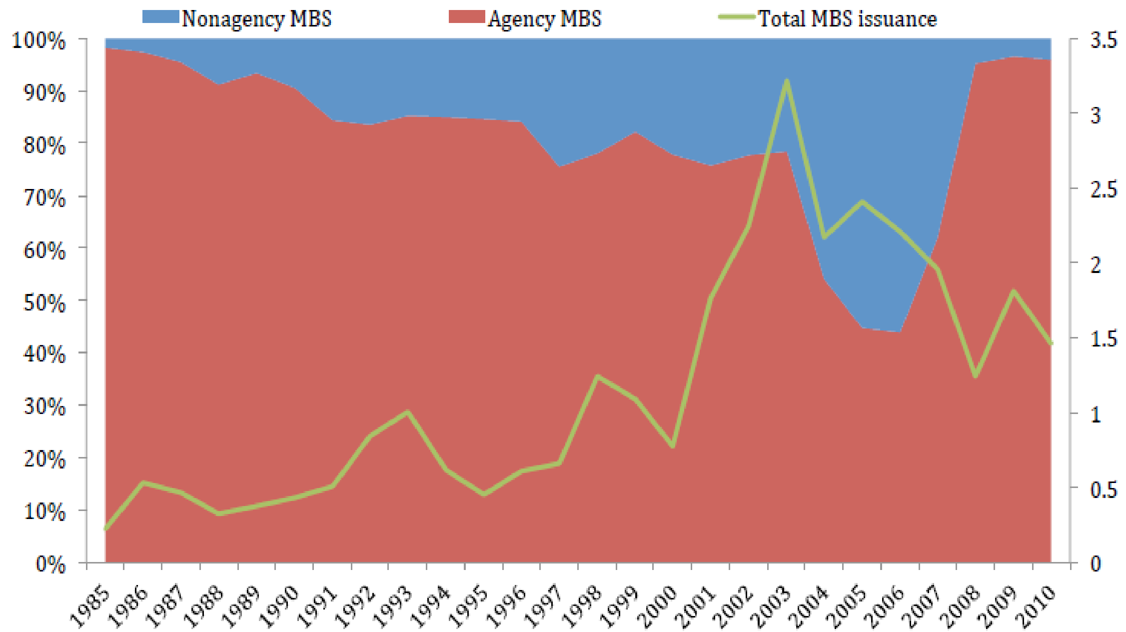


Graph provided by: http://weakonomics.com/2012/06/27/why-is-no-one-talking-about-india/

Exhibit 3

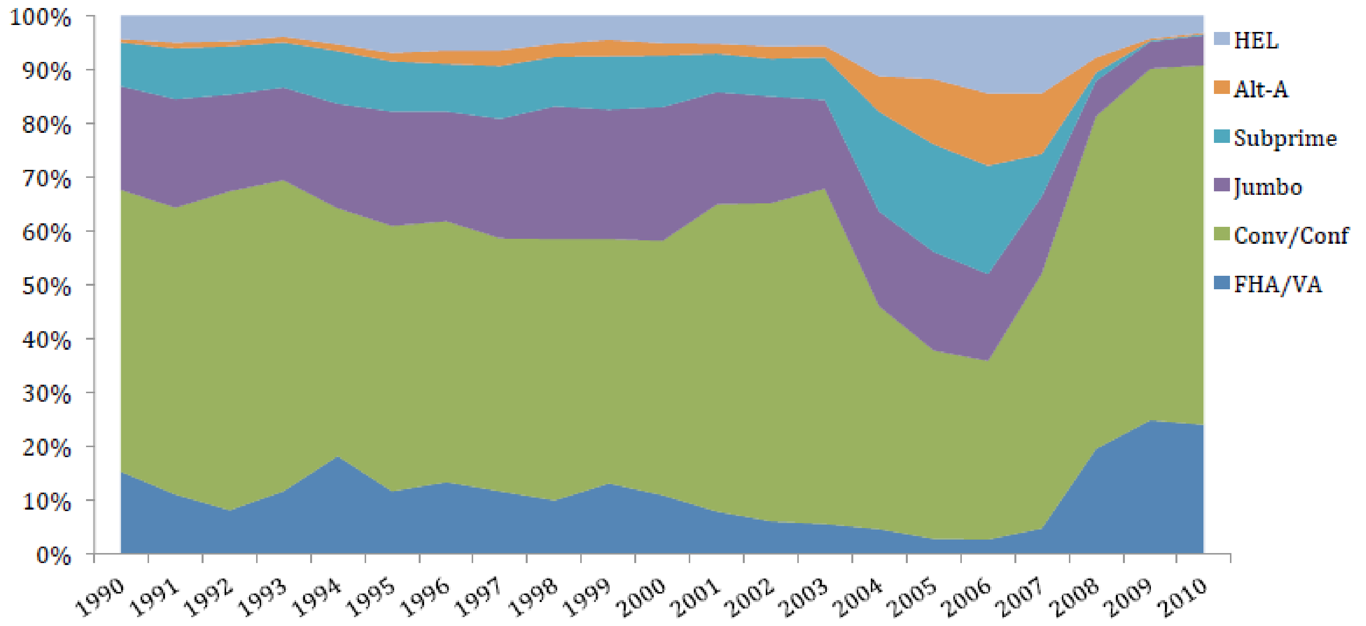
U.S. mortgage-backed securities issuance, 1985-2010

Market share, percent *MBS Issuance, Real 2010 USD trillions*



Note: Agency MBS issuance includes GNMA, FHLMC, and FNMA.
Source: FDIC, A New Plateau for the U.S. Securitization Market, Chart 2; Inside MBS & ABS; GNMA, FHLMC, FNMA.; 2011 Mortgage Market Statistical Annual, Vol. 2, p. 9; Bureau of Labor Statistics.

Exhibit 4



Source: 2011 Mortgage Market Statistical Annual, Vol. 1, p. 20.

Exhibit 5

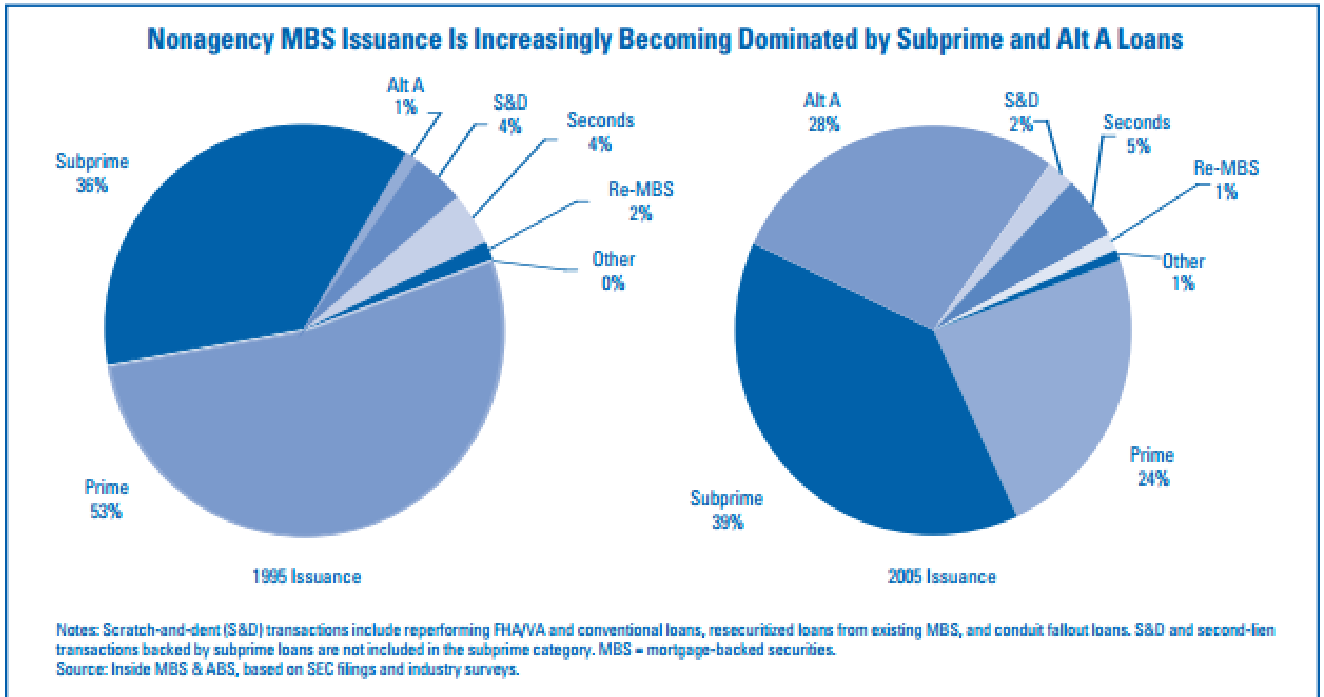


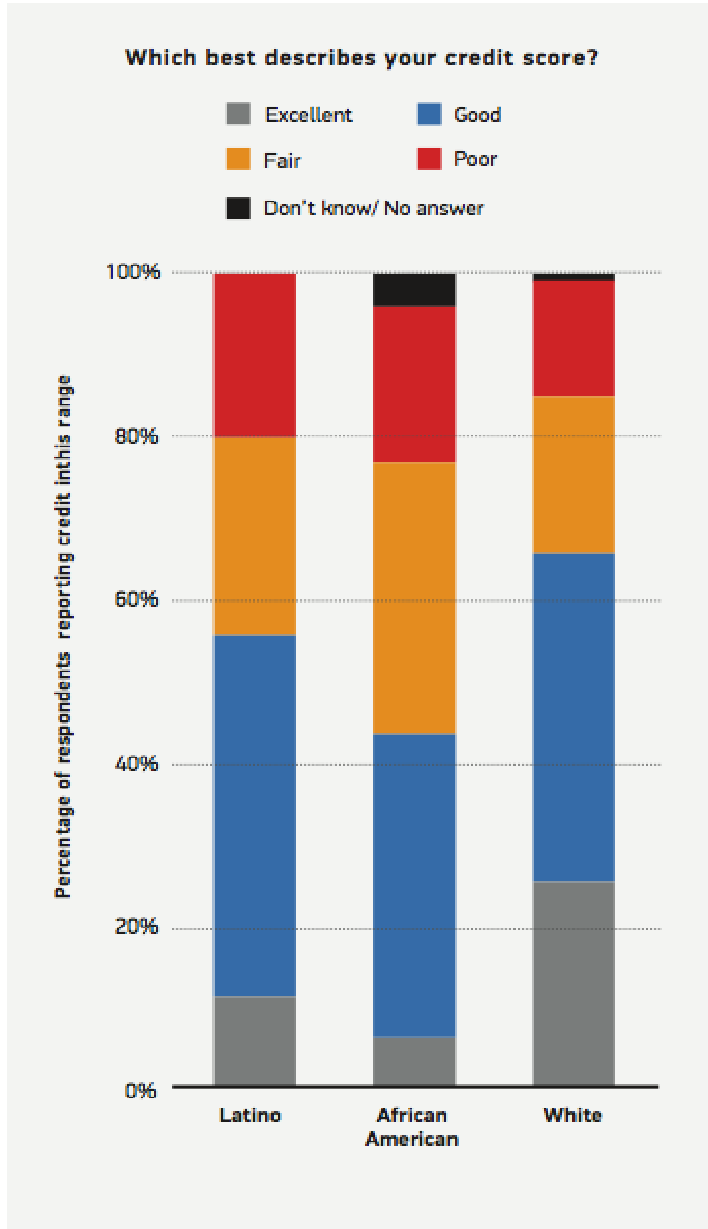
EXHIBIT 6						
Interest rate	0.045			**Balance Due**		
Payment	**Amount**	**Interest**	**Principal**	350,000	Monthly Payments	**$1,773.40**
1	$1,773.40	1312.5	$460.90	$349,539.10	Interest over loan life	**$288,423.49**
2	$1,773.40	1310.772	$462.63	$349,076.47		
3	$1,773.40	1309.037	$464.36	$348,612.11		
4	$1,773.40	1307.295	$466.10	$348,146.01		
5	$1,773.40	1305.548	$467.85	$347,678.16		
6	$1,773.40	1303.793	$469.61	$347,208.55		
7	$1,773.40	1302.032	$471.37	$346,737.19		
8	$1,773.40	1300.264	$473.13	$346,264.05		
9	$1,773.40	1298.49	$474.91	$345,789.14		
10	$1,773.40	1296.709	$476.69	$345,312.45		
11	$1,773.40	1294.922	$478.48	$344,833.98		
12	$1,773.40	1293.127	$480.27	$344,353.71		
13	$1,773.40	1291.326	$482.07	$343,871.63		
14	$1,773.40	1289.519	$483.88	$343,387.75		
15	$1,773.40	1287.704	$485.69	$342,902.06		
16	$1,773.40	1285.883	$487.52	$342,414.54		
17	$1,773.40	1284.055	$489.34	$341,925.20		
18	$1,773.40	1282.22	$491.18	$341,434.02		
19	$1,773.40	1280.378	$493.02	$340,941.00		
20	$1,773.40	1278.529	$494.87	$340,446.13		
21	$1,773.40	1276.673	$496.73	$339,949.40		
22	$1,773.40	1274.81	$498.59	$339,450.82		

EXHIBIT 7

0.08			Balance Due			
Amount	**Interest**	**Principal**	350,000			
$2,568.18	$2,333.33	$234.84	$349,765.16		**Monthly Payment**	$2,568.18
$2,568.18	$2,331.77	$236.41	$349,528.75		**Interest over the life**	$574,543.36
$2,568.18	$2,330.19	$237.98	$349,290.76			
$2,568.18	$2,328.61	$239.57	$349,051.19			
$2,568.18	$2,327.01	$241.17	$348,810.03			
$2,568.18	$2,325.40	$242.78	$348,567.25			
$2,568.18	$2,323.78	$244.39	$348,322.86			
$2,568.18	$2,322.15	$246.02	$348,076.83			
$2,568.18	$2,320.51	$247.66	$347,829.17			
$2,568.18	$2,318.86	$249.31	$347,579.85			
$2,568.18	$2,317.20	$250.98	$347,328.88			
$2,568.18	$2,315.53	$252.65	$347,076.23			
$2,568.18	$2,313.84	$254.33	$346,821.89			
$2,568.18	$2,312.15	$256.03	$346,565.86			
$2,568.18	$2,310.44	$257.74	$346,308.12			
$2,568.18	$2,308.72	$259.46	$346,048.67			
$2,568.18	$2,306.99	$261.18	$345,787.48			
$2,568.18	$2,305.25	$262.93	$345,524.56			
$2,568.18	$2,303.50	$264.68	$345,259.88			
$2,568.18	$2,301.73	$266.44	$344,993.44			
$2,568.18	$2,299.96	$268.22	$344,725.22			
$2,568.18	$2,298.17	$270.01	$344,455.21			

Exhibit 8

FIGURE 4. | AFRICAN AMERICAN & LATINO HOUSEHOLDS ARE MORE LIKELY TO REPORT WORSE CREDIT THAN WHITE HOUSEHOLDS



Data taken from Demos' 2012 National Survey on Credit Card Debt in Low- and Middle- Income Households, a nationally-representative survey of 997 low and middle-income American house- holds who carry credit card debt.