The QM/QRM Impact Problems*

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The publication of the proposed regulations for risk retention and those for ability to repay have touched off a discussion of the disparate impact those rules might have on lower income and minority borrowers. The discussion, however, is focused in great part on the impact these rules will have and the possible criticism lenders will receive if they follow these rules. Attempts are being made to persuade the appropriate regulators to make substantial changes in the proposed rules before finalizing them.

One proposed rule would require a 20 percent down payment on a loan to exempt a lender from retaining some credit risk on that loan to support its repayment. That is generally known as the Qualified Residential Mortgage proposal.

The ability to repay provisions are those that incorporate the concept of a Qualified Mortgage exception to the general rule that a lender must show that it reasonably believed the borrower had the ability to repay a loan at the time of origination. Qualified mortgages are mortgages that meet certain conditions or standards. Penalties for violating the ability to repay standards are severe, equally as severe as those that violations of HOEPA loans face. These include class action lawsuits, statutory damages, and an ability to utilize the violations as a defense to foreclosure at any time during the life of the mortgage.

These are the proposals that have generated an outpouring of reaction from a wide spectrum of commentators and has created the formation of unusual alliances of consumer activists and mortgage lenders. The main complaint is that it favors richer, whiter borrowers over all others.

The regulators, unfortunately, are limited on what they can do that will address the disparate impact issues.

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Disparate impact

The concern facing consumer activists is that the requirement in the QRM for a 20 percent down payment will lead to fewer loans for those individuals that have less accumulated net worth, and therefore, the impact will be felt disproportionally with poor and minority persons. Similarly, the standards that must be met in the QM exception likewise will have a disparate impact on lower income and minority borrowers. The demographics generally support that conclusion — there will be a disparate impact on the poor and minorities if these regulations are finalized as proposed.

The Fair Lending statutes have been interpreted to prevent practices that lead to this kind of result even if there is no disparate treatment of the borrowers, unless there is a valid business reason for engaging in those practices and no good alternative to the practices. It is unlikely that the Justice Department or the Bureau would target lenders that simply followed that part of the regulation that required a 20 percent down payment, but if the lenders make exceptions in some cases, then there would be room for inquiry by Justice on the equal use of such exceptions.

A similar disparate impact will follow from lending consistent with the ability to repay rules. Fewer loans will be made to those who don't qualify as QMs because of the draconian penalties, and those losing out will be the same groups that are affected by the risk retention rules.

Who's to blame for the result?

What is Ozian about the discussion, however, is that the regulators are being targeted as the primary reason this result might happen, and lenders are concerned that they will be the next to be blamed, particularly if the QRM rule is finalized as proposed.

The regulators would argue that they are simply promulgating a regulation that they believe follows the intent of the Act. There is a dispute on whether or not loan to value is an appropriate ratio to be included as a standard, since there is fairly clear legislative history that suggests that it should not, notwithstanding the direction in the Act that the regulators define Qualified Residential Mortgage based on underwriting and product features that historical loan performance data indicate result in a lower risk of default (LTV is a decent predictor, but it also moves the needle on the number of loans that will be made). If in fact they are using a feature for

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limitation of the exception that should not be used, then to that extent they should be blamed.

In no way, however, should there be anyone blaming lenders who follow meticulously whatever terms and conditions are found in the final regulation. Yet, there is concern that because the impact on protected groups will be disproportionate, the government might hold the lenders in some way accountable for that.

On QM, that issue has flown under the radar a bit. Since the concept that borrowers must have the ability to repay a loan is more difficult to criticize as a standard, and since the proposal itself is somewhat complex with the different approaches to a Safe Harbor, it has not led to as much rhetoric about the number of consumers that will not get loans. But let there be no mistake — the boundaries of QM, when joined with the severe penalties for violating the ability to repay standard, will result in fewer loans made to the entire population, and that means that the LMI and minority populations will suffer disproportionally. Unlike the QRM dispute, however, the agencies have not been heavily criticized for their QM proposal.

A dispassionate view of the issues would place the blame for disparate impact squarely on Congress, notwithstanding how one might come out on the question of the regulators use of LTV in the QRM standards.

It was Congress that passed the Dodd-Frank Act, and that is the Act that is being interpreted by the regulators. As soon as the Act articulated that lenders would have to show that the borrower had the ability to repay a loan; as soon as the Act said that securitized loans would be divided into those bearing retained risk and those not bearing retained risk and that the latter should be driven by loans that have a lower risk of default; and as soon as the Act established draconian penalties for violating QM, the die was cast. Loans will be made proportionally greater to rich majority members of society, and less proportionally to poorer minority members, almost regardless of what regulations are promulgated to implement them.

The purpose was laudatory — prevent the origination of poorly underwritten loans. But the consequences went beyond that.

Brief unofficial history of these provisions

QM and ability to repay have the longest history, going back to a variety

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of articles by various consumer groups and professors on the need to ensure that lenders made that basic determination at the time a loan was originated. As early as 1994, HOEPA introduced the term into the statutes, and North Carolina used it in 1999 when it passed its seminal predatory lending bill. In Congress, the term surfaced in bills in both the House and the Senate in 2000 (Sarbanes, Schumer, LaFalce, Schakowsky, e.g.), and were in almost all of the predatory lending bills introduced thereafter. The federal regulators issued guidelines stressing the importance of determining the ability of the borrower to repay their loans.

It is important to note, however, that these provisions were directed at subprime lending, not at prime lending, and in great part directed at refinancing practices. In refinancing, homeowners lose equity they have already accumulated in their homes. In purchase loans, however, they only can lose whatever equity they put up for a down payment, and in many cases during the 2000s, borrowers didn't have to put up any equity.

The theory of the ability to repay provisions is simplicity itself — before you make a loan, be confident that the borrower can repay the loan. The problem with the theory, of course, is that the resolution of the question of whether or not you knew or should have known doesn't take place on the date the loan is made but later when the borrower stops paying its monthly loan payments, and it doesn't take place in some sterile forum before a just arbiter of decisions, but in hectic courtrooms often before a totally unpredictable jury. At that point, the nuanced arguments of attorneys take over and if the matter goes to a jury, the outcome is not predictable.

But whatever the test, the only result that can follow from a requirement that the borrower must be seen to be able to repay the debt will be a reduction in lending, since absent such a requirement, some lenders will make loans based on sloppy judgments of the borrower's ability to repay, the need to produce a certain quota of loans, the hope that things will get better and the borrower can refinance in the future, or just the gamble that the originator will be gone by the time the loan goes sour. Once specific standards are placed in the requirement relating to income, assets, debt, value of collateral, credit history, etc., then the flexibility of lenders is reduced, and some loans won't get made.

The risk retention requirement has an equally ancient history, but not in the form that it has become law. Lenders that have securitized loans have

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always been required to make representations and warranties about the loans they securitize, and have been required to buy them back regularly over the years when loans fail those reps and warranties. But the activation of the turbulent lending of the 2000s generated comments by knowledgeable people that securitization had permitted lenders to avoid those responsibilities. The assumption made was that if they had to retain some risk, even after securitization, then they would make better underwriting decisions. From that followed the risk retention provisions of Dodd-Frank, conceived in its first forms by the Frank staff and jointly placed into law by the combined actions of the two Houses of Congress.

Solutions

The two proposals will make it harder for the mortgage market to run amuck as it did in the 2000s, and in that sense, they will be successful. They will be very unsuccessful, however, in sorting out housing finance equally between different income, ethnic and racial groups. Said another way, they will be successful in sorting out funding as dictated by the statute and regulations, but that won't result in equal proportionate funding for all of those sectors.

What can the agencies do? What they cannot do is to change the statute — it is what it is. They can eliminate in the QRM proposal some provisions not required by the statute, such as the premium capture cash reserve account or the use of LTV if further research supports the arguments against its use. In QM, the Bureau can adopt a legal safe harbor, and better rationalize the factors that are currently proposed to be used in the calculation of points and fees. Adopting provisions such as that will lead to the origination of more and prudent loans, and perhaps open up the market for a proportionally larger segment of the low income and minority groups. It won't change the fact, however, that proportionally more lower income and many minority citizens will be unable to purchase homes. Those are simply the demographics of our population, combined with the Congressional decision to require tighter limitations on mortgage lending.

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