

# the PENDULUM SWINGS

Dodd-Frank's  
Impact on the  
Housing Market

by James P. Gaines



**T**he Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 swung the mortgage credit pendulum from the “way too easy” side to the “almost ridiculously difficult” side of the underwriting spectrum. Tighter mortgage credit has constrained a robust housing recovery and formed a general deterrent to economic recovery.

The Dodd-Frank Act, most of which went into effect January 10, 2014, directly affects both primary and secondary mortgage markets. The act created the Consumer Finance Protection Bureau (CFPB) to oversee primary loan activity and to protect the mortgage consumer. The act also enacted broad sweeping regulations in the financial markets to provide general oversight of Wall Street and financial institutions that play a large role in the sale of mortgages in the secondary market.

## Focus on Primary Mortgage Lending

Perhaps the single most significant overall provision of Dodd-Frank’s mortgage rules creates potential legal liability for a lender if a borrower defaults and can show that the lender failed to evaluate his ability to repay (ATR) adequately. The potential liability for an ATR violation is substantial, exposing creditors and assignees to “enhanced” damages — actual damages, statutory damages in an individual or class action, court costs and attorney’s fees, plus special statutory damages equal to the sum of all finance charges and fees paid by the consumer. Violations may also provide the borrower with a defense to foreclosure.

Of course, lenders always evaluated a borrower’s ability to repay a loan, but now the lender can be sued and held liable for

substantial damages if it fails to evaluate that ability per the general ATR guidelines in the law. In essence, it permits the courts to second guess a lender's evaluation of a borrower's creditworthiness. To date, no cases have actually gone through the full legal process, so for the time being no one is exactly sure what it all really means. Lenders do not know how strictly the courts will interpret the requirements or the level of liability that will be imposed under given circumstances.

Loan underwriting has never been an exact science, and lenders historically employed a great deal of flexibility and a substantial amount of subjectivity to evaluate prospective borrowers. That flexible subjectivity has been effectively removed until lenders better understand the complete ramifications of their decisions.

The new CFPB ATR guidelines apply to closed-end consumer credit transactions secured by a one-to-four-unit dwelling. The guidelines do not apply to home equity lines of credit; loans with terms of 12 months or less; the construction period of construction-to-permanent loans of 12 months or less; loans secured by a time-share; or reverse mortgages. Community development financial institutions, community housing development organizations and down payment assistance providers are exempt under certain conditions. Nonprofit, low- to moderate-income housing lenders that follow their own underwriting guidelines are generally exempted as well.

The CFPB has issued general requirements for lenders to meet the ATR requirements. Before making a loan, the lender must document and verify the borrower's:

- current or reasonably expected income or assets;
- credit history;
- current employment status;
- monthly payment on the mortgage;
- monthly payment on any simultaneous loans (such as a second mortgage);
- monthly payment for mortgage-related obligations (taxes, insurance, HOA fees);
- current total debt obligations (alimony, child support, student loans); and
- monthly debt-to-income ratio and any other income.

The regulations are not specific as to how the factors are to be applied or evaluated. However, the lender is required to verify all information from independent third parties. The

*Nearly 30 percent of survey respondents indicated that if their banks stop residential lending activity, there are no other institutions within their market area to fill the void.*

lender must document everything and be able to reproduce the documents in the future (no more no-doc/low-doc loans).

The act provides a "safe harbor" for lenders against potential ATR-based liability by defining a qualified mortgage (QM). QM loans may be either general QM or agency QM loans and offer maximum legal protection to the lender as long as the interest rate is no more than 1.5 percentage points greater than the prevailing average prime offering rate (APOR). Other provisions offering a "rebuttable presumption" of ATR compliance attach to loans when the interest rate exceeds 1.5 percentage points above the APOR, which, by definition, indicates high-risk mortgage loans.

The mandatory product feature requirements for a general QM are:

- upfront fees or points cannot exceed 3 percent of the loan;
- qualified mortgages cannot exceed 30 years;
- no interest-only periods, negative amortization or ballooning principal;
- the total debt-to-income (DTI) ratio of the borrower must be equal to or less than 43 percent (also applicable to jumbos); and
- the loan must be a prime loan, which means its interest rate cannot vary significantly from the national average prime mortgage rate.

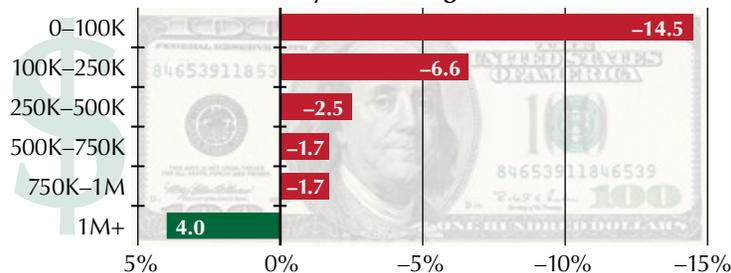
If a loan is eligible to be sold to Fannie Mae or Freddie Mac or to be insured by FHA, it is automatically classified as an

agency QM. If Fannie, Freddie or HUD (FHA's controlling agency) adopts guidelines looser than the CFPB's definition of a qualified mortgage, lenders will be able to make mortgages on those looser terms without fear of legal liability.

Agency QMs allow lenders to make loans beyond the parameters of the general features itemized previously. According to recent data from the American

Enterprise Institute's National Mortgage Risk Index report, half of the home purchase loans analyzed during a recent month had down payments of 5 percent or less, and 22 percent had a debt-to-income ratio greater than 43 percent. Among the FHA loans included in the analysis, 35 percent had a FICO score below 660 and 42 percent had a DTI greater than 43 percent. All of the loans analyzed were Dodd-Frank qualified mortgages.

**Percent Change in Home Sales From a Year Ago by Price Range**



Source: National Association of Realtors, April 2014

**Independent Bankers Association of Texas  
2014 Member Mortgage Survey  
Sent to Smaller Community Banks**

**Table 1. The Dodd-Frank Act rules significantly change the residential mortgage landscape, with changes to appraisals, “ability to repay” and “qualified mortgage” requirements, expanded servicing rules, and much more.**

<b>In response, has your bank decided to:</b>	<b>Responses (Percent)</b>	<b>Responses (Count)</b>
Stop making residential mortgage loans	13.3	19
Limit types of residential mortgage loans it makes	53.1	76
No change	33.6	48
		<b>143</b>

**Table 2. “Ability to repay” (ATR) is the hallmark of the Dodd-Frank Act changes to residential mortgage lending underwriting. Banks that make qualified mortgages (QM) have a safe harbor from consumer claims relating to ATR.**

<b>In response, has your bank decided to:</b>	<b>Responses (Percent)</b>	<b>Responses (Count)</b>
Make only QM loans	41.0	57
Offer both QM and other residential mortgage loans	53.1	76
No change	24.5	34
		<b>139</b>

**Table 3. If your bank reduces or stops residential mortgage lending in your trade area, are there other institutions that can fill that void?**

	<b>Responses (Percent)</b>	<b>Responses (Count)</b>
Yes, there other institutions in the area that appear willing to make these loans	70.4	95
No, there are no other banks or financial institutions	29.6	40
		<b>135</b>

Source: Independent Bankers Association of Texas, 2014 Member Mortgage Survey

## Impacts and Implications of Dodd-Frank

The full impact of the Dodd-Frank Act will depend on how the mortgage and housing markets play out over the next couple of years. No doubt, unforeseen issues will arise that will require clarified or new regulations to fix. At present, a few practical effects are apparent.

First, traditional lenders will focus on making QM loans or “rebuttable presumption” higher-priced loans. The legal uncertainties surrounding all other loans remain unsettling. At the same time, however, some lenders will be exploring the option of providing non-QM loans due to the high demand for the product type. A substantial number of borrowers cannot comply with a 43 percent total debt-to-income ratio, for example.

Secondly, the influence of Fannie Mae, Freddie Mac and HUD on the market will be pervasive as any loan they agree to purchase or insure automatically qualifies as a QM loan. The underwriting guidelines for the agencies will generally dictate the type and features of mortgage loans that will be made for the time being. Ironically, at a time when Congress and the administration are debating eliminating Fannie and Freddie, Dodd-Frank has made them even more significant to the market.

The home loan market in the short run will be much less diverse with a greater homogeneity of product. This standardization will result in greater market systemic risk: if all lenders make similar loans, and these loans wind up being riskier than expected, the losses will be greater and more widespread. If the

required product features prove too tight, the housing market will become constrained, thereby depressing the general economic contribution of housing and making homeownership more difficult. The potential market-constraining aspect of QMs became apparent in the original proposed standards which called for a minimum 20 percent down payment. That requirement was removed in the final version; no required minimum down payment is included at all.

Making the underwriting for mortgage loans tighter significantly reduced the effective demand of lower-income, first-time homebuyers. The under-\$100,000 sector of the home market, which includes many lower-income, first-time buyers, fell nearly 15 percent in April (see figure below). The \$100,000 to \$250,000 home price segment that further incorporates many first-time move-up buyers has declined nearly 7 percent in 2014.

Far more than just ATR and QM are defined and regulated by the CFPB. New rules and regulations have been created (or are forthcoming) covering virtually every aspect of the home loan process, including:

- appraisal requirements, fees, processes and approvals;
- all fees and services related to the loan, such as title insurance;
- loan servicing processes and compliance;
- foreclosure, forbearance and/or loan modification requirements upon default or delinquency;

- RESPA, Truth-in-Lending and almost every other home lending law; and
- documentation, verification and reporting to other government agencies any potential discrepancies or questionable activities by a prospective borrower, such as taxes paid on the source of the borrower's down payment.

These days, with some financial institutions being labeled as "too big to fail," the Dodd-Frank/CFPB requirements may make other financial institutions "too small to comply." The financial cost to comply with the new and expanded loan underwriting requirements may lead some institutions to leave the primary mortgage market.

In its 2014 Member Mortgage Survey, the Independent Bankers Association of Texas, which covers primarily smaller community banks throughout the state, found that many institutions will stop making loans altogether or limit their residential lending to QM loans only.

Among the survey responses, 13.3 percent of the banks said they were going to stop making residential loans, and 53 percent of the respondents indicated they would limit the types of mortgage loans offered (Table 1). Among those that expect to continue to make residential loans, 41 percent indicated they have decided to make only QM loans (Table 2). Perhaps most significantly, nearly 30 percent of survey respondents indicated that if their banks stop residential lending activity, there are no other institutions within their market area to fill the void (Table 3).

The Dodd-Frank Act transformed the home mortgage market from loose, easy credit to tighter, more restrictive home loan originations. The market reality, however, is that a substantial number of buyers need more liberal financial terms and less severe underwriting to purchase a home.

As with most things, mortgage loan originators will ultimately sort through the maze of requirements, rules and regulations to satisfy the demand of homebuyers for home financing. The less severe purchase requirements by Fannie and Freddie along with FHA's increasing role as the main support for lower-income homebuyers will provide QM protection to loan originators. Eventually, private secondary market participants will learn how to price the risk to satisfy the market demand as well. 📌

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## THE TAKEAWAY

The Dodd-Frank Act puts the risk of mortgage defaults on residential mortgage originators by making them liable if borrowers default. The requirements force lenders to make safe, "vanilla" loans with lower default risk.



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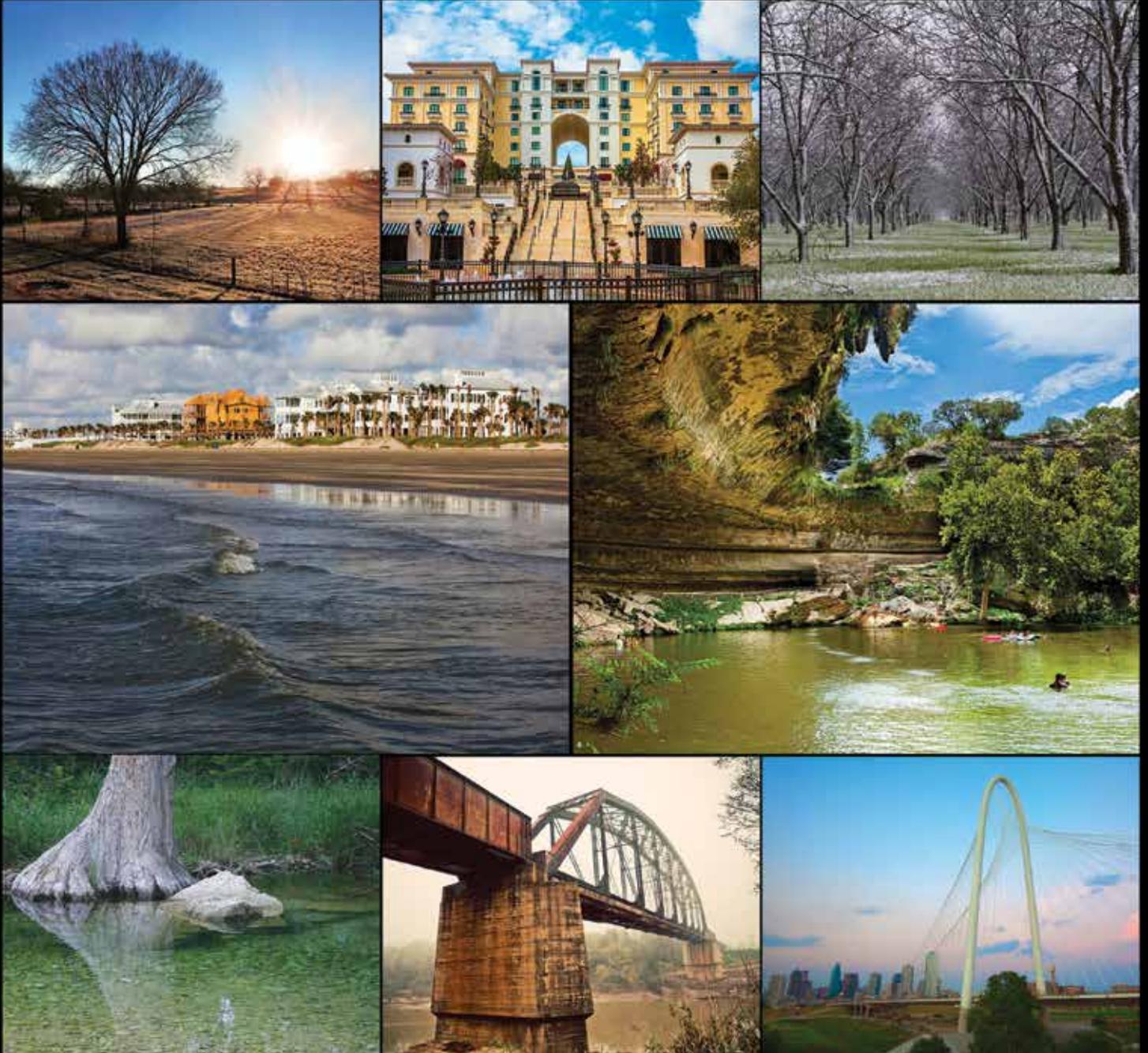
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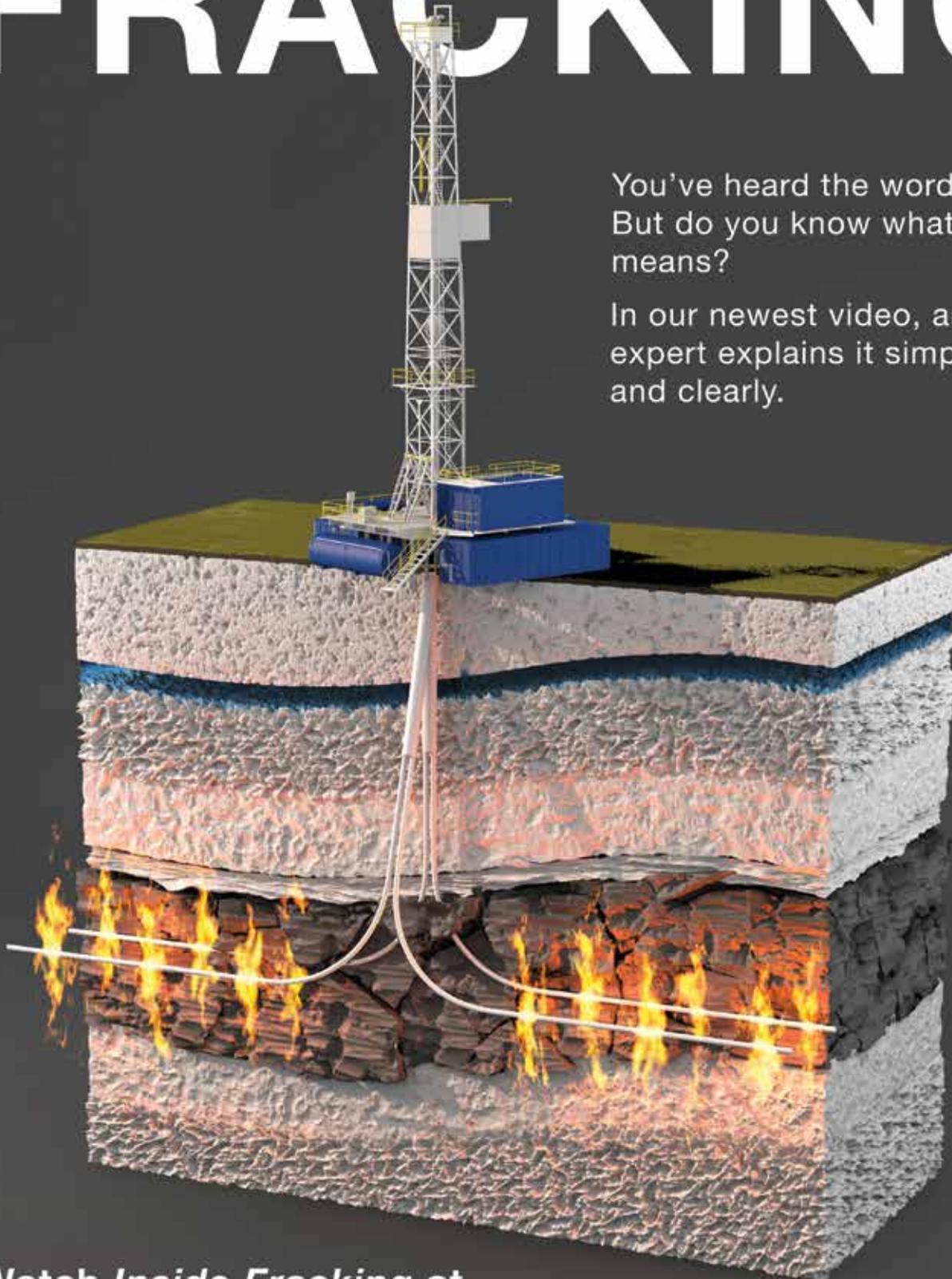
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