X. Mortgage Origination Standards

A. Introduction

In the decades leading up to the 2008 real estate crisis, banks and other lending institutions generally have been free to underwrite loans as they see fit.[1] No mandatory minimum underwriting or origination standards exist.[2] The only soft standards in place have come from internally developed loan policies or market norms established by subsequent loan purchasers.[3] During the real estate bubble, economic incentives and opportunities overwhelmed sensible lending practices.[4] Lenders were able to originate a loan and quickly sell it to securitizers, abandoning all of the risks associated with holding a loan to maturity and still collecting fees simply for originating it.[5] In addition, the secondary market, including both private parties and government-sponsored enterprises (GSEs), gradually accepted loans with lower underwriting standards due to political pressures and profit incentives.[6] With the secondary market willing to assume more risky loans and only self-imposed origination standards to slow or stop lenders, originators marketed more complicated and exotic loans to consumers who would prove unable or unwilling to make their payments to collect a higher volume of origination fees without any risk.[7] However, some lenders, frequently community banks or credit unions, did not participate in many of these activities. These institutions maintained more traditional lending business models, generally keeping a loan for its full term.

B. Role in the 2008 Real Estate Crisis

As noted, market conditions and the regulatory environment created strong incentives to issue complex and exotic mortgages that

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[1] *See* THE FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT, xvii, xxiii-xxiv (2011).
[2] *See id.*
[3] *Id.* at xxvi.
[4] *Id.* at xix-xx, xxvi.
[5] *Id.*
[6] *Id.*
[7] *Id.* at xxiii ("[L]enders simply took eager borrowers' qualifications on faith, often with a willful disregard for a borrower's ability to pay.").

were of low quality.[8] The mortgages were considered low quality because many had loan-to-value ratios ("LTVs") well in excess of the customary 80% of the value of collateral, many were in amounts greater than 100% of the home's value, and lenders often required little to no borrower documentation of salary or other means to repay the loan.[9] Further, many mortgages were interest only, contained adjustable interest rates, required balloon payments, or contained other risky features.[10] These features justified the increased risk of the less-than-desirable credit by allowing greater profitability.[11] In addition to the extra profit for the long-term note holder, the originators would collect an origination fee and could sell the loan without retaining any risk.[12] Thus, the incentives were present for all parties to ignore any "soft" underwriting guidelines that were present.[13] Lenders stretched or ignored the origination standards in their loan policies because of increased profitability of originating and selling or securitizing the loans.[14] In addition, government-sponsored enterprises ("GSEs"), including Fannie Mae and Freddie Mac, accepted lower-quality loans under increased political pressure to provide lower-income borrowers with increased amounts of home loan credit.[15] Due to the increased profitability of security and derivative sales, other commercial secondary market participants lowered or ignored the origination standards they usually required of loans they purchased.[16]

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[8] *Id.* at xviii-xx, xxvi.
[9] *Id.* at xxiii ("During the same year, 68% of "option ARM" loans originated by Coutrywide and Washington Mutual had low- or no-documentation requirements.").
[10] *Id.* ("Nearly one-quarter of all mortgages made in the first half of 2005 were interest-only loans.").
[11] *Id.* at xxii.
[12] *Id.* at xvii.
[13] *See id.* ("There was an explosion in risky subprime lending and securitization, an unsustainable rise in housing prices . . . . Yet there was pervasive permissiveness; little meaningful action was taken to quell the threats in a timely manner.").
[14] *Id.*
[15] PETER J. WALLISON, AM. ENTER. INST., DISSENT FROM THE MAJORITY REPORT OF THE FINANCIAL CRISIS INQUIRY COMMISSION, 11 (2011).
[16] THE FINANCIAL CRISIS INQUIRY REPORT, *supra* note 1, at xvii ("Financial institutions made, bought, and sold mortgage securities they never examined, did not care to examine, or knew to be defective . . . .").

C. Current State of Regulations and Currently Proposed Solutions

Currently, there are no required origination standards as to the quality or required features of the mortgage granted. However, the federal banking agencies have proposed rules that could deeply affect the standard to which mortgages are written.[17]

1. Ability-to-Repay Standards and the QM

On April 29, 2011, the Board of Governors of the Federal Reserve System proposed provisions requiring lenders to consider a borrower's ability to repay the mortgage by implementing minimum underwriting standards.[18] However, the banking agencies may ultimately revise the proposed rules drastically prior to finalizing them. This is especially true because the new Bureau of Consumer Financial Protection ("CFPB") has acquired the rule writing authority for the final rules from the Federal Reserve under the powers given to the agency by the Dodd-Frank Act.[19]

As currently drafted, the provisions require a lender to make a good faith evaluation that the borrower has the financial ability to repay the mortgage.[20] The provisions apply to any closed-end consumer mortgage secured by a dwelling,[21] which does not have to be the borrower's principal dwelling.[22] However, the provisions do not apply to home equity lines of credit ("HELOCs"), reverse

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[17] Credit Risk Retention, 76 Fed. Reg. 24,090, 24,090 (proposed April 29, 2011); Regulation Z; Truth in Lending, 76 Fed. Reg. 27,390, 27,390 (proposed May 11, 2011).

[18] Regulation Z; Truth in Lending, 76 Fed. Reg. 27,390, 27,390 (proposed May 11, 2011).

[19] §§ 1002, 1022 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, 1955, 1980 (2010); Kerri Panchuk, *CFPB Expects Ability-to-Repay Rule by Early Next Year*, HOUSING WIRE (Sept. 20, 2011, 8:15 AM), http://www.housing wire.com/2011/09/20/cfpb-expects-ability-to-repay-rule-by-early-next-year (The qualified mortgage standard is a provision outlined in Dodd-Frank . . . . [s]till, . . . the CBFP is a key player when it comes to the ability-to-repay provision.").

[20] Regulation Z; Truth in Lending, 76 Fed. Reg. at 27,390.

[21] *Id.*

[22] *Id.*

mortgages, timeshare plans or temporary loans less than twelve months.[23]

The provisions offer several methods for a lender to comply with the rules.[24] First, a lender may simply originate a loan after considering and verifying eight factors.[25] The factors that must be considered are the borrower's current income or assets, current employment status, monthly payment amount for the mortgage to be originated, simultaneous monthly payments for other current loans, monthly payment of other mortgage-related debt obligations (e.g. insurance, taxes, etc.), other current outstanding debt obligations, monthly debt-to-income ratio ("DTI") or residual income (RI; amount of income leftover after debt payments), and credit history.[26] The provisions do not establish minimum requirements for any of the factors, but the lender must consider and verify all of them.[27] The provisions provide a potential cause of action for the borrower if the lender fails to adequately consider and verify any of the factors.[28]

Alternatively, under the proposed rules, lenders may originate "qualified mortgages" ("QMs") to satisfy the provisions' requirements. The proposed rules provide two alternatives for the definition of a qualified mortgage.[29]

i. QM - Alternative 1

The first definition provides legal safe harbor for any QM that is originated.[30] Under this proposal, qualified mortgages are those that contain no "risky features."[31] Risky features include negative amortization, interest-only payments, balloon payments and terms over thirty years.[32] Here, the lender must verify the borrower's income or assets used in the credit decision, similar to the minimum

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[23] *Id.*
[24] *Id.*
[25] *Id.*
[26] *Id.*
[27] *Id.*
[28] *Id.* at 27,392 ("[A] consumer who brings a timely action against a creditor for a violation of rules issued under TILA Section 129 may be able to recover special statutory damages equal to the sum of all finance charges and fees paid by the consumer.").
[29] *Id.*
[30] *Id.*
[31] *Id.*
[32] *Id.*

underwriting standards above.[33] The rules greatly limit the fees that may be charged on QMs.[34] Finally, originators of adjustable-rate mortgages must base underwriting decisions on the highest rate possible within five years of origination.[35]

ii. QM - Alternative 2

The second alternative definition provides only a rebuttable presumption of legal compliance for any mortgage that meets the QM requirements.[36] In accordance with the requirements of Alternative 1, this definition includes: prohibition of risky features, verification of the borrower's income or assets used to determine credit worthiness, fee limits and consideration of the interest rate within five years of origination.[37] In addition to these requirements, when originating qualified mortgages under Alternative 2, lenders must consider and verify employment status, simultaneous debt obligations and payments, monthly DTI ratio or RI and credit history.[38]

The ability-to-repay provisions may be largely redundant for community bankers that make loans with the intent to hold them. The provisions, though, are intended for lenders who originate loans with no intent to hold them to maturity, and thus, have no stake in whether the credit is ultimately repaid. Although the provisions may help to meet this goal, many feel there could be more efficient ways to satisfy this end. In fact, a broad rule that a lender must consider the borrower's ability to repay when extending credit for residential mortgages, coupled with examiner enforcement should suffice. Regulators could handle the discretion necessary in enforcing a broad provision. Although failing to clearly define what constitutes adequate consideration of a borrower's ability to repay may cause uncertainty, this is preferable to creating more paperwork for lenders. However, if this course is taken, borrowers should not be allowed a private cause of action under these provisions. Using such a flexible

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[33] *Id.* at 27,391.
[34] *Id.* ("The total points and fees do not exceed 3% of the total loan amount . . . .").
[35] *Id.*
[36] *Id.*
[37] *Id.*
[38] *Id.*

definition of ability to repay would open the floodgates of private party suits on any default.

2. Risk Retention Rules and the QRM

On May 11, 2011, a group of federal agencies, including the Board of Governors of the Federal Reserve System, the Securities and Exchange Commission and Office of the Comptroller of the Currency, proposed a second set of rules that would directly impact mortgage origination standards.[39] These rules would require any party that securitizes mortgages to retain 5% of the loan's risk.[40] This is meant to force securitizers to have "skin in the game," which should incentivize them to consider the borrower's ability to repay the credit.[41]

An exception, however, is made for residential mortgages underwritten to a certain standard, called qualified residential mortgages ("QRMs").[42] There is concern that this exception will lead to a "gold standard" mortgage and establish de facto minimum origination standards for all mortgages.[43] This comes from the presumption that members of the secondary mortgage market will only accept loans from which they securitize and retain no risk.[44] The QRMs must: (1) meet certain specific DTI ratios at both the beginning and the end of the mortgage term; (2) limit the LTV ratio to a maximum of 80%; (3) include a 20% down payment; (4) contain no "risky" features; and (5) be written only when the borrower's

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[39] Credit Risk Retention, 76 Fed. Reg. 24,090, 24,090 (proposed April 29, 2011).

[40] *Id.*

[41] Joe Adler, Donna Borak & Cheyenne Hopkins, *Cheat Sheet: Details of Regulators' Plan for Risk Retention, QRMs*, AMERICAN BANKER (Mar. 28, 2011, 3:48 PM EDT), http://americanbanker.com/issues/176_60/risk-retention-1035082-1.html ("[T]he 'sponsor' of the securitization, which takes the loan from the originator before it is packaged for the secondary market, is required to 'hold the risk retention'").

[42] Alex Ulam, *Meet QM, QRM's Sister - Only Tougher*, AMERICAN BANKER (May 7, 2011, 7:25 PM EDT), http://www.americanbanker.com/issues/176_88/meet-qm-qrm-sister-1037208-1.html.

[43] Adler, Borak & Hopkins, *supra* note 40 ("The so-called 'qualifying residential mortgage' test is one of the most important pieces of the risk retention plan because many lenders are hoping to make loans exclusively according to those terms.").

[44] *Id.*

credit history contains no 60-day delinquencies in the previous two years, shows the borrower is current on all debts and has had no bankruptcies or foreclosures in the previous three years.[45] The purpose of the exception is to exclude from risk retention requirements those mortgages that are substantially less risky.[46] This is the rare provision that has drawn criticism from both community groups and financial institutions.[47] Community groups feel that lenders will only originate QRMs, denying credit to low-income but creditworthy borrowers.[48] Conversely, lenders want a rewrite because they feel the provisions are too strict in both the level of risk retention and the narrowness of the QRM exception.[49] However, in addition to the QRM exception, mortgages ultimately sold to GSEs would also be exempted.[50]

D. Other Regulatory Alternatives

1. Continued Self-Regulation

One view is that lenders and secondary market purchasers generally have done a good job prior to the financial crisis and will continue to do so without government intervention.[51] Further, banks and other lenders have learned from the losses they incurred on lower quality mortgages and will maintain more strict internal underwriting requirements in their loan policies.[52] If GSEs are done away with and the GSE-backed loans are removed from the market, the market will correct itself and proper incentives will be put into place.[53] The private secondary market will correct itself and require tougher origination standards because they incurred losses on subpar loans

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45 Credit Risk Retention, 76 Fed. Reg. at 24,117-18.
46 Adler, Borak & Hopkins, *supra* note 40.
47 *Id.* ("The risk retention proposal is likely to draw protests from the banking industry and concern from lawmakers because it is so sweeping and may reshape the entire lending business.").
48 *Credit Risk Retention Rule Comment Period Extended,* News Bulletin (Morrison Foerster), June 10, 2011.
49 *Id.*
50 Adler, Borak & Hopkins, *supra* note 40.
51 DISSENT FROM THE MAJORITY REPORT OF THE FINANCIAL CRISIS INQUIRY COMMISSION, *supra* note 15, at 2 ("[T]he *sine qua non* of the financial crisis was U.S. government housing policy . . . .").
52 *Id.* at 29.
53 *See id.* at 2-3, 11-12 (stating that GSEs were a major factor in the crisis).

they held when the securities market froze.[54] As such, any regulation of the area could be said to be unnecessary or even intrusive.[55]

2. Required Lender Methodology for Origination Standards

Alternatively, the federal banking agencies could require banks to submit a supporting methodology for how they determine a borrower's ability to repay the loan, which would have to be approved and monitored by regulators. A lender would need to provide past results to support the predicted success of the methodology and monitor actual origination to ensure compliance and continued success of the method. This allows a lender some flexibility to determine a method that has brought success, while ensuring that the plan is effective through examiner supervision.

3. More Explicit Underwriting Guidelines or Requirements

One of the most restrictive alternatives would be for the federal agencies to issue very specific residential mortgage guidelines.[56] Specific loan requirements similar to those in QRM could be codified as minimum underwriting standards. For example, the agencies could specify a minimum LTV ratio that should be maintained on all consumer home mortgages as either a strongly suggested guideline or a definitive requirement.

4. Bifurcated Origination Standards Based on Lender's Intent

Furthermore, the federal banking agencies could adopt different origination standard regulations for each loan originated, depending on the lender's intent. If a lender holds the loan for a fixed amount of time, such as ten years or until maturity, such a lender may be free to originate the loan as they see fit. However, if a lender intends to sell or does sell the loan within that period, such loans should be subject to one of the ability-to-pay regulations discussed

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[54] *Id.* at 29 ("The appropriate policy choice was to reduce or eliminate the government's involvement in the residential mortgage markets . . . .").
[55] *Id.*
[56] THE FINANCIAL CRISIS INQUIRY REPORT, *supra* note 1.

above. This would enable select loans to be made available to borrowers at current costs of credit. It would also appease those arguing that the regulation is not applicable to their business model, such as community banks or credit unions. This does not eliminate concerns, though, of the increased cost of securitization.

5. Regulation Focusing on Transparency of Credit Decisions in the Secondary Market

Another approach would be to enact regulation that encourages transparency in communicating mortgage and borrower characteristics among securities.[57] Presumably, if all subsequent purchasers know the intrinsic qualities of the loan, the secondary market would refuse to purchase loans written to subpar standards that carry greater risk of loss.[58] These market incentives would then essentially push lenders to write to the optimal level of risk.[59] This method of regulation may be the least intrusive to lender operations. All mortgage-backed securities would simply disclose detailed information about any credit decisions made in the underlying mortgages. Information about the loan's features, the borrower's credit information, and the collateral securing the loan would be readily available.

E. Conclusion

When determining whether adequate mortgage origination standard regulations are in place, the purpose for such regulations must be determined. Mortgage origination standard regulation should be used to realign the incentives of the mortgage underwriting business to encourage sound lending and discourage originating the highest quantity of mortgages available for sale to the secondary market, regardless of credit quality.[60] Because transparency of origination standards is the least intrusive way to achieve this, it should be pursued for any securities with underlying mortgages.

In addition, the definition of QRM should be written in a way to not restrict the traditional flow of credit. Assuming incentives are realigned through registration and transparency regulation, there

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[57] *Id.* at 5.
[58] *Id.* at 12.
[59] *Id.*
[60] *Id.*

is no reason to create a very narrow definition of QRM that will negatively impact lending. With lending incentives realigned in this way, the risk retention percentage need not be so high and should be lowered beyond the 5% currently proposed. In sum, having transparency in origination standards lessens the burden on risk retention regulations.

Finally, the ability-to-repay provisions, though, potentially redundant to current community banking operations, may be relevant to some lenders.[61] The best way to maximize efficiency in this situation is to pursue bifurcated regulation based on the lender's intent. Banks pursuing traditional lending models and holding loans to term should be permitted to continue operations in this way. Lenders who plan to sell the loans, though, should be required to consider the borrower's ability to repay in some manner. The most flexible manner to enforce this is to provide the lender with compliance options. To comply, the lender may choose to meet agency-specified underwriting standards, similar in specificity to those provided in the QM definition, though not necessarily as strict. Alternatively, the lender may opt to develop a regulator-approved methodology for considering a borrower's ability to repay the mortgage as laid out above.

Although there is an initial learning curve and compliance cost to this scalable regulatory structure, it is the most effective way to pursue mortgage origination standards. It allows those who contribute the least additional risk to the system to escape without much regulatory interference or costs; thus, keeping the cost to consumers relatively fixed. In addition, it eliminates much of the overlap provided by currently proposed regulation with current bank practices and other proposed legislation. Finally, the regulatory structure incentivizes lenders to make decisions based on the credit risk of the transaction to a scalable extent, increasing where those incentives have been absent in recent years.

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[61] *See* DISSENT FROM THE MAJORITY REPORT OF THE FINANCIAL CRISIS INQUIRY COMMISSION, *supra* note 15 (stating that many loans being defaulted on had deficiencies, which Fannie and Freddie would not have ordinarily acquired, but for government housing policies).

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