WILL DODD-FRANK ENCOURAGE A REPEAT OF THE HOUSING BUBBLE?

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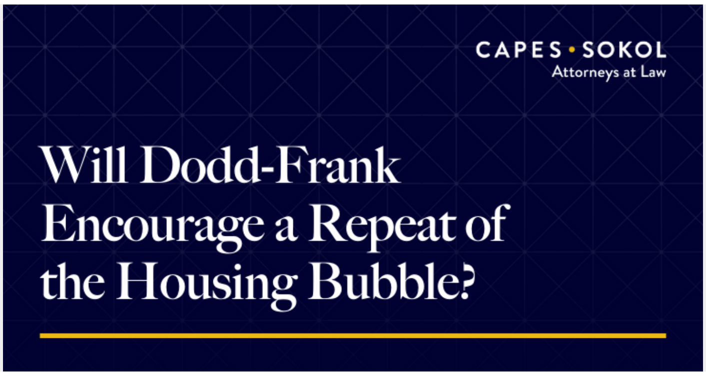

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It appears that rule-making agencies are likely to gut a provision from the Dodd-Frank financial overhaul law that requires securitizing lenders to retain at least 5% of the credit risk in all but the safest real estate secured loans.

"Great Recession"

The FDIC, FRB, SEC, Federal Housing Finance Agency, and Department of Housing and Urban Development are the agencies responsible for this rule. Anyone born before 2007 should know that the "**Great Recession**" was precipitated by the burst of an enormous housing bubble inflated by irresponsible mortgage brokers and lenders who made billions of dollars of home loans without adequate regard for the ability of borrowers to repay the debt.

This occurred as a result of abuse of mortgage backed securities. But the inventors of that method to monetize mortgage loans should not bear the blame. In simple terms, a mortgage backed security is a securitized pool of loans secured by real estate. By selling the loans, lenders and brokers quickly convert individual mortgage loans to cash. In turn, the pools are sliced into securities that are sold to investors. In theory, the investors' risk is hedged because each pool is comprised of many mortgages.

Thus, the risk of default is spread among many loans. As long as those loans are underwritten according to reasonable standards, a mass default is extraordinarily unlikely. If one or two borrowers default, the rest should continue making their payments and the investors will enjoy a return.

Initially, this worked quite well. Responsible lenders were encouraged to lend to credit worthy borrowers by selling the loans into pools. More money was available to lenders to facilitate additional home purchases and refinancings. The safety of the investments in mortgage backed securities was further enhanced in many cases by Fannie Mae and Freddie Mac which guaranteed loans written to the standards of those institutions.

The Housing Bubble

The housing bubble burst due to a catastrophic failure in a number of mechanisms driven largely by greed. Mortgage brokers make their money by taking a commission on each loan. Mortgage lenders have a choice. They can sell the loan (and shed the risk) for a small but quick profit or they can make a safe but conservative return on their investment by retaining the note and mortgage. As the popularity of mortgage backed securities increased, lenders were encouraged to sell more and more of their loans. While the "commission" on each sale was relatively small, the more sales that occurred, the more aggregate profits were realized by the lenders.

As demand grew, some brokers and lenders paid less attention to underwriting standards. Likewise, as qualified borrowers completed their home purchases and refinancings, the supply of loans meeting good underwriting standards and the requirements of Fannie Mae and Freddie Mac diminished.

Since demand for mortgage backed securities remained strong, there was increasing pressure and incentive for brokers and lenders to look the other way when loan applications were not up to snuff. As the bubble neared its bursting point, some unscrupulous mortgage brokers and lenders actively encouraged unqualified borrowers to submit falsified loan applications.

Still, as long as home values increased, even unqualified borrowers could quickly flip their properties, pay off the mortgage and buy an even more expensive property with easy financing. When home values began to flatten, the house of cards came tumbling down.

Dodd-Frank

Against this backdrop, it is understandable why Dodd-Frank required lenders to keep some skin in the game. In theory this would encourage lenders to self-regulate and more closely scrutinize the credit worthiness of their borrowers. Now, however, an unlikely coalition seems to be working to gut that simple requirement. Some of the usual suspects – the banking and housing industries – are involved. They are joined by consumer advocates worried that poor people may be unable to obtain loans unless standards are relaxed.

In opposition to the regulation change is a coalition comprised of Dodd-Frank co-sponsor, Barney Frank:

> *"Sheila C. Bair, former chairwoman of the FDIC; and the American Enterprise Institute, a conservative research group that has rarely . . . found itself in agreement with Mr. Frank on a regulatory issue."*

Dodd-Frank establishes three categories of mortgages.

Three Categories of Mortgages Under Dodd-Frank

The most restrictive in terms of underwriting requirements are qualified residential mortgages ("QRM") which do not require skin in the game if pooled and sliced into securities.

Somewhat less restrictive are qualified mortgages ("QM"). Under rules scheduled to take effect January 10, 2014 established by the Consumer Financial Bureau, these loans are supposed to be made only to consumers who can afford them, but the requirements are relatively low. The lender must verify that the borrower's income and total monthly debt obligations are no more than 43% of pretax income.

There is no down payment requirement or limit on how much may be lent relative to the value of the collateral. It is noteworthy that before the lending excesses that led to the Great Recession, banks generally refused to make loans on which repayments would exceed 35% of the borrower's income.

So what is about to change?

Regulators are under pressure to relax the definition of QRM so that essentially any mortgage that meets the QM standard will also meet the QRM standard.

As Mr. Frank wrote in a comment letter,

> *"the result, would be two categories, those that fall below standards and probably shouldn't be made and those that could be made and would not be subject to risk retention."*

Mr. Frank added that,

> *"the overwhelming majority of commentators who are interested in building, selling or promoting the sale of housing to lower-income people support effectively abolishing risk retention. I should note that if all of these people were correct in their collective judgment, we would not have had the crisis that we had."*

The comment period on the proposed new rule relaxing the risk retention requirement expired October 30. Let's hope that the collective memory of our banking, securities and regulatory bodies is longer than the average five year old's. If it is, the regulations will require the lenders to keep some of their own skin in the mortgage-lending game.