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Proposed regulations affect mortgage lending

Beginning in 2008, the housing market saw a spike in foreclosures and the failure of countless lending institutions. Low lending standards, a rise in subprime lending and subsequent mortgage delinquencies were cited as leading causes of the 2008 financial crisis and following recession. Borrowers, taking advantage of lower lending standards, withdrew equity from their homes and as a result many homeowners found themselves "underwater" — owing more on their mortgage than the value of their home.

By KRISTEN J. PHILLIPS

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In February 2011, Congress created the Consumer Financial Protection Bureau (CFPB), in part as an effort to address predatory lending practices that contributed to the financial crisis. According to the CFPB website, their central mission is "to make markets for consumer financial products and services work for Americans," and it is tasked with promoting "fairness and transparency for mortgages, credit cards, and other consumer financial products and services."

This past January the CFPB proposed amendments to the Real Estate Settlement Procedures Act (RESPA), which they assert will "address fundamental problems" regarding the mortgage industry and reduce, what they call, "avoidable foreclosures."

The CFPB regulatory amendments would prohibit home loans that offer deceptive terms and "teaser rates" as well as those loans that require no documentation from borrowers. Banks and lenders would also be required to ensure a borrower's "ability to pay their mortgage." These standards are in direct response to the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act, which requires creditors to meet new compliance guidelines, including a determination by a lender that a borrower can repay their mortgage loan.

The proposed standard which the CFPB would use to measure affordability limits loans where a borrower's combined debt payments would exceed 43 percent of their income. Loans where the borrower's debt-to-income ratio is below the 43 percent level would be termed "qualified mortgages." Promotion of qualified mortgages will be advantageous for lenders because they would be sheltered from legal action for reckless or abusive lending practices.

The CFPB's 43 perecnt proposal is meant to ensure that borrowers are only receiving mortgages that they can pay and not taking on loans that increase the likelihood of default. Federal regulators hope that with the creation of qualified mortgages banks will be encouraged to lend again.

However, the CFPB's proposed 43 percent limitation does not necessarily protect all borrowers. A 43 percent debt-to-income ratio would be far more restrictive to low-income borrowers. The specified debt limit may also make it more difficult for low-income borrowers to qualify for a loan — even a much needed refinance. A better way to accomplish the CFPB's goal may have been to create a sliding scale by which to measure the debt-to-income ratio rather than a flat percentage.

While the "ability to pay" standard might cause you to ask "isn't this a requirement of every loan?" The answer leading up to the financial crisis was, actually, no. Not all lenders and mortgage brokerages adhered to even minimal credit requirements. Lenders approved loans for borrowers who did not qualify for traditional loans and would ultimately not be able to maintain the payments. Additionally, before the financial crisis lending guidelines allowed borrowers to take what seemed like unlimited equity from their homes.

While subprime and predatory lending was a factor in the financial crisis, several economic studies have concluded that many foreclosures were not the result of unscrupulous lending, but conscious decisions by consumers to walk away from their mortgages and "underwater" properties. During the years leading up to the financial crisis borrowers were able to purchase homes with mortgages requiring little or no down payment.

Also prevalent were equity-stripping refinance transactions that afforded borrowers the opportunity to cash out the equity from their home. With the ensuing financial crisis these "underwater" homeowners made the financial decision to walk away from their homes. In many cases foreclosures were caused by

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declining property values, loss of jobs or other factors and not the specific loan terms. The CFPB fails to address these scenarios.

When the CFPB proposed regulatory amendments to go into effect in January 2014 the changes may have minimal impact on current lending practices. In most cases the lending market has already addressed the majority of concerns that initiated the CFPB proposals. Lending standards have tightened, loans other than a fixed rate mortgage are no longer dominant or widely available. Additionally, interest only loans or loans with prepayment penalties or negative amortization are rare, if available at all. Government intervention may not be necessary given the changes lenders have already made due to the market reaction to the financial crisis and recession. The mission of CFPB is clear, but it is not clear if they will have an impact on the lending market.

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