

the Mortgage Commentary

June 2011

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Did you ever hear about QRM?

Probably not. It is an acronym for Qualified Residential Mortgage as included in the Dodd-Frank Wall Street Reform and Consumer Protection Act, signed into law July 21, 2010 with an effective date of July 21, 2011.

Dodd-Frank is a voluminous bit of legislation (no big surprise) and it addresses a multitude of matters related to financial institutions across the country. The purpose of the Act is to do pretty much what its title suggests: reform Wall Street and protect consumers.

And it is the direct result of the disaster that saw the mortgage meltdown and the collapse of long time revered financial institutions.

Obviously there were weaknesses in "the system" that led to the disaster and just as obviously these weaknesses need to be addressed so as to prevent (if possible) a recurrence of those tragic events.

The purpose behind the laws and regulations is not being questioned here. Nor are the intentions of those who have worked on them.

However, there is such a thing as over reach and there are such things as unintended consequences. And it is those that we discuss in this month's Mortgage Commentary.

Furthermore, our discussion is limited to one narrow aspect of Dodd-Frank only — the part that deals with QRM, qualified residential mortgages.

Here's the deal.

Dodd-Frank defines what a QRM is. Lenders originating mortgage loans that do not fall within the definition of QRM must retain 5% of the amounts of such loans (when they are sold into the secondary mortgage market) to share the risk of their performance.

At present, the lender passes this risk on to the purchaser of the mortgage. Unless, of course the lender keeps the loan in its portfolio.

This means that for a \$500,000 loan which is sold on the secondary market, the lender must set aside \$25,000.

At first blush, this sounds sensible. If you assume all loans outside the definitions of Qualified Mortgages (QM) are risky and that all loans which meet the definitions are not risky, then, sure, lenders originating the risky loans should bear part of the risk.

If, however, the definition of Qualified Mortgages is unduly restrictive, that's another story.

Lenders have only two choices if a loan does not qualify. They can originate the loan and increase the costs (charge higher interest rates) — or they can simply cease to originate such loans.

Here are some loan types that Dodd-Frank says do not meet the definition of a Qualifying Mortgage.

INTEREST ONLY loans regardless of loan to value.

NEGATIVE AMORTIZATION loans.

LOANS with less than 20% equity.

LOANS with debt to income ratios above 28% front end and 36% back end.

These limitations may not seem important to borrowers who do not need or want any of the above loans. And a case could certainly be made that some of these loan characteristics were among those things that led to the mortgage meltdown.

As such, they should therefore be eliminated or severely restricted. And if they are originated, lenders who originate them should retain some of the long term risk rather than simply pass that risk on to investors.

But as we point out on the following page, such draconian rules should be closely examined before they become set in stone.

History has demonstrated that is far more difficult to remove a bad law than it is to pass one in the first place.

And we believe some parts of Dodd-Frank are not good.

–the present \$729,750 High Balance Conforming Loan Limit will expire as of October 1st unless Congress extends it–

Problems with Dodd-Frank

\$729,750 loans disappearing

While Dodd-Frank's QRM regulations will prevent some risky loans from being made, it will also prevent some loans that have absolutely no risk from being made. In essence, Dodd-Frank replaces underwriting with legislation. It prevents mortgage underwriters from making decisions based on a holistic view of a borrower's overall financial picture.

For example, Dodd-Frank says that a Qualified Mortgage can have maximum debt to income of 28% (mortgage debt to income) and 36% (all debt to income).

Assume a borrower with millions in assets, \$20,000 additional monthly income after making all payments with ratios of 45% and 50%. Is that loan more risky than a borrower with ratios of 28% and 36%, with two month's reserves after close and \$500 left over each month for food and fuel? Hardly.

And what if that same high income borrower wanted a loan with an interest only option for purposes of flexibility in his financial planning? He has plenty of income to make amortizing payments. Shouldn't his loan be considered a Qualified Mortgage?

Dodd-Frank was set to become effective on July 21. And the initial period for the Federal Reserve to receive comments about the Act was to end June 10. BUT this has been extended to August 1. This is good news. Hopefully some of the more draconian aspects of the Dodd-Frank Act will be addressed and revised.

Dodd-Frank is a voluminous bit of legislation. It's a tough slog to read through it. But it is important and will have a profound impact on the mortgage industry, housing values, home owners and home buyers. Do some research. Google Dodd-Frank. Then contact your Senators, Representatives and let them know what you think.

You can also access the Federal Reserve's webpage. www.FederalReserve.gov. Click on "contact us".

We have mentioned in previous Commentaries that the present \$729,750 High Balance Conforming Loan Limit will expire as of October 1st unless Congress extends it.

And our elected officials in Washington are finding it impossible to reach agreement on anything these days. So, don't count on an extension. The new limit on October 1st will be \$625,500.

TO BE CLEAR, THE LOAN MUST CLOSE BY THE END OF SEPTEMBER IN ORDER TO QUALIFY FOR THE PRESENT \$729,750 LIMIT. AND BACKING UP FROM THAT DATE, JULY 15TH WOULD BE THE LATEST RELATIVELY SAFE DATE TO MAKE LOAN APPLICATION.

How important is this date? Let's do some math.

Let's assume you want a 30 year fixed rate loan of \$725,000, and that rates will be the same on July 15th (when you lock the loan) as they are now.

The High Balance Conforming rate is 4.625% today, so your monthly payment would be \$3,727.51.

The Jumbo rate is 5.375% with monthly payments of \$4,059.92. So the impact of the change is \$336.41.

Without going through all the figures, this increases required income from roughly \$130,000 per year to \$140,000 to qualify for this loan.

These figures are not precise, but close enough to illustrate the point.

So — keep these dates in mind: July 15th to make loan application and September 30th to close the loan.

For you or anyone you know who needs a loan amount that will be impacted by the coming change, there's no time to waste.

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