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Defining a 'qualified' mortgage

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Too-easy credit and millions of bad loans made during the U.S. housing bubble paved the way for the financial calamity and Great Recession that followed. Today, by contrast, credit is too tight. Mortgage loans are particularly hard to get, creating a problem for the housing market and the broader economy.

Banks are key to the availability and cost of mortgage loans, but so too are bank regulators. And as directed by the Dodd-Frank financial reform, regulators will soon make some important decisions affecting who can obtain mortgages and what interest rates will prevail.

One key decision involves the definition of what the Dodd-Frank law calls a "qualified mortgage." Lenders probably will only make qualified mortgages, because if the loans ever go into default, they could be sued by disgruntled borrowers. The legal and reputational costs would be prohibitive. How qualified mortgages are defined, therefore, will essentially set the boundaries of the U.S. mortgage market.

Basically, a qualified mortgage will be one that a household can reasonably be expected to repay. That makes sense: No one wants to see another housing boom and bust, and barring lenders from making loans that borrowers can't afford seems like a good way to prevent that.

But deciding which loans will qualify will be tricky. Lenders look at potential borrowers from many angles before extending credit: How much of its income will a household need to put into debt repayment? How large is the down payment? Does the borrower have a job with a stable income? What is the borrower's credit score? Mortgage loans can also vary widely, with features that make sense for one borrower but not for another.

If the government defines "qualified" too tightly, mortgages will become even harder to get than they are now. Minority, lower-income and first-time home buyers will have the most trouble, and many will be blocked from homeownership. Ironically, these are the very groups that financial reform was supposed to protect.

A narrow qualified-mortgage standard will ensure that the federal agencies Fannie Mae, Freddie Mac and the Federal Housing Administration continue to dominate U.S. mortgage lending. This is because Dodd-Frank presumes that any loans these agencies make are qualified by definition. Yet no one wants the government to remain the nation's main mortgage lender. Thus, while the definition of a qualified mortgage should be set judiciously, it should be broad. At the very least, the limits for private lenders should match those used by the government agencies.

Wherever the lines are set, however, the definition of a qualified mortgage should be crystal clear. There needs to be a bright, well-understood line between what is acceptable and what is not. Fuzzy definitions open to interpretation will leave lenders uncertain and thus overly cautious, restricting credit and crippling the market.

To further allay these worries, lenders should be given legal safe-harbor protection, making it difficult for borrowers who receive qualified mortgages to sue. The risk that this will allow too many bad mortgages to be made is meaningfully smaller than the risk that, without such protection, many more good mortgages will not be made.

A second looming decision with big implications for mortgage credit involves something called the "qualified residential mortgage" rule. Although the name is similar, this is quite different from the qualified-mortgage definition, and is designed to curb bad lending by forcing lenders to hold a financial stake in their riskiest mortgages.

Under Dodd-Frank, a lender must hold 5 percent of any loan that isn't a "qualified residential mortgage" (QRM) so that if it later goes sour, the lender loses something, too. This makes sense in principle, but like the qualified-mortgage rule, the devil is in the details. These are quite complicated, reflecting regulators' fear that lenders will work hard to circumvent any rule. But complexity adds to costs, and as a result, non-QRM loans threaten to have meaningfully higher mortgage rates than QRM loans.

Since Dodd-Frank stipulates that loans made by the federal agencies are qualified residential mortgages by definition, how QRM is defined will help shape the federal role in the mortgage market. If the definition is too narrow, private lenders won't be able to compete, given the higher interest rate they will need to charge to compensate for the extra risk. The government will thus continue to dominate mortgage lending in the near term. On the other hand, if Fannie Mae and Freddie Mac are privatized down the road, a narrow QRM definition could significantly shrink the government's role in the mortgage market, potentially threatening the existence of the 30-year fixed rate mortgage loan.

QRM loans should thus be defined broadly enough to include about two-thirds of all qualified mortgages. This is about the share of the mortgage market that was backed by the government before the bubble, when the housing market was on a solid financial foundation.

Whatever regulators decide about the QM and QRM definitions, they need to do it quickly. Without clarity on these rules, mortgage loans will remain difficult to get, holding back housing and the economy. Clear rules also are needed so that lawmakers can finally figure out what to do about Fannie and Freddie, and the role government should play in the nation's housing.

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